12-4-1985

Review of the Department of Corporations, Insurance and Justice Responsibilities in Conversion of Public Benefit Corporations From Nonprofit to Profit Status

Assembly Committee on Finance and Insurance

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December 4, 1985

INTERIM HEARING

Review of Departments of Corporations, Insurance and Justice responsibilities in conversion of public benefit corporations from nonprofit to for-profit status: Case Study — FHP, Inc. and Foundation Health Plan conversions and involvement of additional health plans

10:00 a.m. to 4:00 p.m.
Room 447 — State Capitol
Sacramento, California

0109A

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86-5-93

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10:00 a.m. to 4:00 p.m.
Capitol Hearing Room 447

A G E N D A

I. INTRODUCTION AND OPENING STATEMENT

A. Honorable Alister McAlister, Chairman
Assembly Finance and Insurance Committee

II. REGULATOR GENERAL DESCRIPTION OF CONVERSION

A. Department of Corporations

B. Department of Justice

III. PERSPECTIVES ON DETERMINING VALUE OF A BUSINESS CONVERSION

A. Mr. Thomas L. Kelly, Partner
Peat, Marwick, Mitchell & Company

B. Ms. Mary C. Tanner, Managing Director
Shearson Lehman Brothers, Inc.

C. Discussion of Perspectives

IV. CONVERSION AND VALUATION FOR NONPROFIT HOSPITAL SERVICE PLANS AND INSURERS

A. Bruce Bunner, Commissioner
Department of Insurance

B. Discussion of Insurance Department Presentation

V. SPECIFIC BACKGROUND ON TWO CASE STUDIES

A. Presentation by Department of Corporations

1. Franklin Tom, Commissioner

VI. LUNCHEON RECESS: 12 noon to 1:00 p.m.

VII. WITNESSES REQUESTING TO TESTIFY

A. Mr. Jim Shultz
Consumers Union

B. Video Presentation

VIII. EXAMINATION OF KNOX-KEENE PLAN CONVERSION AND CASE STUDIES

A. Presentation by Department of Corporations

1. Franklin Tom, Commissioner

B. Discussion of Corporations Department Presentation

C. Presentation by Department of Justice

1. Andrea Sheridan Ordin
Chief Assistant Attorney General
Division of Public Rights

2. Carole Ritts Kornblum, Assistant Attorney General
Charitable Trusts/Civil Rights Enforcement Section

3. James R. Schwartz, Deputy Attorney General

D. Discussion of Justice Department Presentation

IX. UNSCHEDULED WITNESSES

X. CLOSING STATMENT

XI. ADJOURNMENT by 4:00 p.m.

ASSEMBLY COMMITTEE ON FINANCE AND INSURANCE
Sacramento, California
December 4, 1985

CHAIRMAN McALISTER: Good morning. Our day-long hearing, at least a day long, will address the significant issues of the value of a company, the value of a company's goodwill, self-dealing agreements, and charitable distribution plans invovled in the conversion of a not-for-profit public benefit corporation, licensed under the Knox-Keene Act to a for-profit status.

Two specific case studies to be examined in depth today are the recently Corporations Department approved conversion of FHP, Inc., a Fountain Valley based plan, for $38 million, and the 1984 Corporations Department approved conversation of Foundation Health Plan, a Sacramento-based plan, for $10.6 million.

We intend to review the responsibilities of the Departments of Insurance, Corporations and Justice in the conversation process. Joining us in our hearing are the members and staff of the Assembly Judiciary, the Senate Insurance Claims and Corporations Committee.

At our hearing, we intend to determine, or at least to explore, the following.

One, how is the value of a company determined and approved by state regulators?

Two, what is the value of a company's goodwill?

Three, what screening criteria needs to be established to evaluate the conversion value? What guildelines are currently in existence to ascertain valuation?

Four, regarding the two case studies, has the Corporations Department ignored other appraisals determining the value of the company, either prior to or after the approval to convert?

Five, why is the Department of Justice in the State of California having to utilize the courts to prevent the Corporations Department from approving a conversion? What factors led the Corporations Department to lower its value of FHP, Inc.?

Six, to what degree is the public receiving a fair price for the company which converts?

Seven, are the State regulators recognizing the role and responsibility of the Department of Justice in protecting the public in these conversions?

Eight, does the Department of Corporations require a financial audit and medical survey prior to conversion, to protect the financial viability of the plan, and to ensure the adequate delivery of health care?

Nine, in light of the Attorney General's interest in the FHP, Inc. conversion, could the Corporations Commissioner have exercised the provisions of Health and Safety Code Section 1352(b), which permits postponement of conversion?

Ten, are the conversion monies distributed for charitable purposes?

Eleven, to what extent are the founders of these companies utilizing tax dollars for private profit-making purposes, which were intended to provide health care?

Twelve, to what extent are the founders of these companies retaining control over the charitable trusts established after conversion? To what extent should the State be able to recoup lost tax revenue from the purchase price of the converted company?

Thirteen, what public disclosures have occurred by the founders of these case study conversions?

Fourteen, in the Foundation Health plan conversion process, on what basis were the insiders provided bonus stock options?

Fifteen, in the offering of stock, were the insiders aware of a company value far above the conversion-approved value?

Sixteen, does the Department of Corporations believe it must maintain a rule prohibiting antitrust violation and encouraging competition, despite explicit responsibilities of this nature vested in the California and United States Attorney Generals and other federal agencies, such as the FTC, and despite the apparent lack of concern by any of these other agencies on these points.

Seventeen, how are plant subscribers and providers benefitted in the conversion process?

Eighteen, to what extent should subscribers be accorded reduced health care subscription rates as an essential part of the charitable distribution plan?

And 19, but perhaps not finally, how many tens of millions of dollars will be lost to the public when the remaining health care service plans decide to seek Corporation Commissioner approval to convert?

My Committee staff has gathered a number of documents which we intend to examine with the Corporations Commissioner and his staff during the afternoon session. We have just received additional documents that we asked for, which we have not had the opportunity to fully examine, although we have scanned them.

My staff has prepared its own chronology for FHP, Inc. in memo formm, and that is contained in your agenda packet. I'm certain, as we progress in the hearing, there may be additional documents which we will request from the Department of Corporations.

All right. We will start with --

MR. JOHNSON: Mr. Chairman --

CHAIRMAN McALISTER: -- the Department of Corporations.

MR. JOHNSON: Mr. Chairman.

CHAIRMAN McALISTER: Mr. Johnson.

MR. JOHNSON: Just a couple of opening comments. I think it's important that the members of the Committee and the audience bear in mind, because there may be some considerable confusion as we go through the day, that we're dealing with two entities known as HFP, Foundation Health Plan of Sacramento, and Family Health Program of Orange County. And I think it would be wise if we kept in mind, it would avoid some confusion in discussing those.

CHAIRMAN McALISTER: Yeah.

MR. JOHNSON: Additionally, I think that it's important that the members of the Committee and witnesses today keep in mind, not only the interest in seeing a maximum amount of money made available to charity in these conversions, but also the importance of competition in the field of providing low-cost health care to the people of California and others around the country.

Clearly, that was the intention of this Legislature in enacting Knox-Keene, and I think it's important that this discussion be conducted in that framework, that we not lose sight of that policy objective of the Legislature to the people of California as well.

CHAIRMAN McALISTER: I think, Mr. Johnson, there would be serious disagreements over the intent on that Knox-Keene Act, of not necessarily to disagree with the generalities you've expressed, but I certainly am going to have some very serious questions of the Department of Corporations, as to their rewriting of the statute, and their apparent interpretation of the statute to mean things that the statute doesn't begin to say.

MR. JOHNSON: Well, reasonable minds, Mr. Chairman, can and frequently do differ on matters of interpretation and matters of particular prohibitions, but I think we can all, as members of the Committee, and hopefully as citizens, agree that the intent, the underlying intent was to foster competition to insure that there wouldbe meaningful competition, and that that competition would result in availability of low-cost quality health care for the people of our state.

CHAIRMAN McALISTER: However, there was never the intention to repeal the law of the charitable trust, or to have non-profit health plans given away to private interests.

I think those two interests can probably be reconciled, but the Department's going to have to show us how they reconciled it in these two deals.

Okay, Mr. Tom.

MR. TOM: Define the parameters?

CHAIRMAN McALISTER: Mr. Tom will give us a general description of the conversion process, and the case studies will be coming later.

MR. TOM: Thank you. Mr. Chairman, members of the Committee and staff. I'm Franklin Tom, Commissioner of Corporations. Perhaps well known to this Committee in other contexts.

And I have with me, to my right, David Meadows, who is our supervising examiner in our health care service plans division. He is the chief examiner in charge of the accounting work and a substantial portion of the conversion work of the health care division of the Department of Corporations. Thank you.

I'm pleased to have the opportunity to not only respond to the Committee's questions and concerns, but the place on the table all of the facts that we have been able to marshall for the Committee's benefit, and for the benefit of ourselves, on the subject of conversion of non-profit health care service plans to for-profit status.

During this first segment, as I understand the wishes of the Committee, I'll address the general process of conversion, and then at a later time will be called back to speak about the specifics of the conversion of FHP and foundation.

Prior to the time that the Knox-Keene Act was enacted in 1975, health care service plans were not permitted to operate on a for-profit status basis. And this was consistent with the general prohibition at the time of the corporate practice of medicine, and was largely dictated by federal requirements for health maintenance organizations to be established on a non-profit basis in order to avail themselves of the benefits in the form of low-interest loans and so forth, that the federal HMO Act provided for non-profit health maintenance organizations.

So for many years in California and elsewhere, non-profit health care plans continued in that form, and were clearly viable, and quite successful in many cases, in part, due to their cost-effectiveness in relationship to the then-existing competition in the key markets that they operated in. And in part due to those federal grants under the federal HMO Act that I referred to earlier.

Over the years, though, the federal grant program has been phased out, and at the same time, in particularly mature markets, as is the case in the California marketplace, fierce price-sensitive competition has developed among the various HMO's for-profit and not-for-profit alike.

The need for capital and the need for key employee incentive that is available only in the for-profit format have compelled a number of formerly non-profit HCSP's to convert to for-profit status, particularly in California, given its competitive market.

So there have really been, in my judgment, two driving forces behind the conversion movement. One is the need for more capital, and the other is the need to have available management equity incentive programs.

And, I might add, insofar as the need for capital exists, that is both in the form of equity capital through the sale of stock, which obviously isn't compatable with a non-profit format, and debt capital, because, except for the very largest of the not-for-profit health maintenance organizations, there is not a significant market at a reasonable price for the debt of non-profit corporations.

The difficulties experienced while attempting to compete as a non-profit corporation against well-capitalized for-profit competitors, has figured very strongly in this trend toward conversion.

The national data show that the for-profit segment of the HMO market is growing significantly faster than the non-profit segment, and that the individual for-profit companies are expanding far more rapidly, in California and elsewhere, nationally, than the not-for-profit counterparts.

Thus, the competitive pressures which are relied on by both the public and the private sector to maintain a containment of costs in the health case field also tend to pressure health care service plans to move -- excuse me -- from a non-profit to a for-profit status.

Simultaneously, I'd like to note that those HCSP's that are most likely to be hurt by the resulting increase in competition from converted plans would disfavor such conversion. A company that is already in a for-profit mode, either because it started out that way, or has previously converted to for-profit, it likely to be hurt by the conversion in the future of non-profits to for-profit status, because they enjoy the advantage, both in the capital markets, and in terms of management incentive programs.

So I think the first issue that perhaps is a legitimate subject of inquiry, should be whether conversions should be allowed at all from non-profit to for-profit status.

It seems clear to me that the Knox-Keene Act, and the other provisions of the Corporations Code that are relevant to this inquiry, clearly contemplate the possibility, and permit the conversion of non-profit HMO's to for-profit status. And this has been the case since the beginning of California legislation in this area.

In my judgment, the ability to convert from non-profit to for-profit status for a fair charitable settlement should be preserved, because it's not only compatible with, but is likely to further extent those competitive elements which in turn will act as appropriate containments for health care costs, due to the increased competition of an open and intensively competetive marketplace.

Now, what is the process of conversion that now exists at the Department of Corporations, and prior to the time when the Department assumed exclusive jurisdiction for these conversions?

What do they have to do to convert from non-profit to for-profit status? Well, prior to 1980, HCSP's were required to obtain the approval of the Office of the Attorney General prior to converting. And during the period from 1980 to 1983, as a result of law changes, these same plans would have had to deal with both the Attorney General's Office and the Department of Corporations, both of whose approval would be necessary for the conversion process to take place.

However, beginning January 1 of 1984, HCSP's are required to secure only the approval of the Department of Corporations prior to conversion. Of course, as we will hear later, in the conversion process, there is normally created a charitable organization which becomes the beneficiary of the charitable value of the converting health care plan. And that charity continues to be, as it has always been, under the oversight -- sorry for the pun on words -- of the Department of Justice.

Section 10821 of the Corporations Code, which was enacted in 1983, provides that as to non-profit HCSP's, all references to the Attorney General in the Non-Profit Public Benefit Corporation Law, and the Non-Profit Mutual Benefit Corporation Law, quote, "Shall, in the case of health care service plans, be deemed to refer to the Commissioner of Corporations." Close quote.

Now, it's our understanding that this section was enacted at the request or with the consent of the Office of the Attorney General, and, of course, the Department of Corporations, inasmuch as regulation of the same transaction, and of the same entity, by two separate agencies of the State, was deemed to be duplicative and unnecessary.

The specific authorization for conversion of non-profit to for-profit status, is found in Section 5813.5 of the Corporations Code. There are a couple of other relevant sections, too, in the Corporations Code, 5820 and 5233.

The former provides a safe harbor ruling relative to articles of incorporation, and the latter expressly excludes from the definition of self-dealing transactions, those which have been passed upon by either the Attorney General, or in the case of HCSP's, the Department of Corporations, before or after the transaction took place.

As a condition precedent to receiving authorization to convert to for-profit status, a non-profit has to make a charitable settlement in an amount, and under terms and conditions, as may be required by the regulatory agency, in this case the Department of Corporations.

The greatest difficulty in a typical conversion, is the determination of the fair value of the charitable settlement within the confines of the law.

A conversion ordinarily contemplates that there is a continuity of management. In all or virtually every case, the converting health care service plan -- and this was true at the time that the Attorney General had exclusive or concurrent jurisdiction, as well as subsequent to 1983, there was a continuity of management.

MR. CONNELLY: Alister, is it all right if I ask a question at this point, just a clarification question?

CHAIRMAN McALISTER: You know, I would really kind of appreciate it if we would all let the Commissioner finish --

MR. CONNELLY: Okay.

CHAIRMAN McALISTER: And then any question anybody wants to ask, we can ask. But I think if we start breaking in, that we're going to break up too much continuity. Go ahead.

MR. TOM: Thank you, Mr. Chairman. In a recent court case, in fact, it had to do with the FHP conversion, which is the only case that we are aware of in which there has been a court test of the appropriateness of a management buyout, this position of permitting a continuity of management and a purchase by the management of the non-profit HCSP, has been validated and approved.

In order to permit this kind of continuity of management, the law does not provide for, or require that there be an auction process for the determination of what is the fair market value. So in this connection, the Department of Corporations has utilized as a guideline for the determination of fair market value, the rules and regulations of the Internal Revenue Service, which have been developed over the years, in connection primarily with evaluation for state tax purposes of privately-held corporations and other assets in decedents' estates.

IRS Regulation Section 20.2131 1-B, defines fair market value in the following way, quote,

> "The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts."

In my judgment, the second relevant question for inquiry of this Committee is whether an HCSP's management should be permitted to participate in such a conversion.

I think the Legislature clearly made a choice in this regard, and that choice was affirmed by the court no more than two months ago, in recent litigation, that the law contemplates and indeed encourages management buyouts.

The reality of life is that a prohibition of any such management buyout would severely reduce the number of conversions, and would condemn the non-converting plans to the disadvantages that non-profit status has resulted, namely, the disadvantage in the capital markets, and the disadvantage in terms of attracting competent managment personnel.

In determining the amount of the charitable settlement, bids and offers of competitor would not -- excuse me. I'm sorry, I misstated.

Standard business valuation techniques used for privately held copmanies are used by the Department of Corporations in establishing the value of health care service plans, in the absence of a conclusive market test, and to evaluate the results of any purported market test.

These techniques primarily include those which are also utilized by the Internal Revenue Service, namely, adjusted book value method, including appraisals, to determine the value of tangible assets, such as real estate; capitalized historic earnings method, which is a capitalization of the earnings potential of the organization; discounted future cash flow method, which is based on projections of cash flow in the future.

These methods have been deemed appropriate for valuation of privately-held companies, pursuant to IRS revenue rulings, and numerous court decisions involving business valuations.

And those are the precedents which we have utilized in going through a similar process with respect to converting HSCP's.

I trust, Mr. Chairman, that this establishes some basic foundation as to our understanding of the law and the process that the Department utilizes in the conversion process.

CHAIRMAN McALISTER: All right. Thank you, Mr. Tom. Mr. Connelly?

MR. CONNELLY: This is an embarassingly naive question, but in determining the charitable amount, are you trying to transfer the full value of the non-profit corporation as as the date of transfer?

In order words, are you trying to get full value for the non-profit corporation to a charitable settlement?

MR. TOM: That's correct, Mr. Connelly. It's the fair value, or fair market value of the company.

MR. CONNELLY: So there's 100 percent of the value of the non-profit corporation, so to speak, at the time of the transfer, is to go to charity.

MR. TOM: That's correct.

MR. CONNELLY: And then, of course, we get into the argument about what the 100 percent is, whether it's $10 or $12.

But do you go back, particularly on the transfers that are inside, the management transfers, is there some procedure or criteria by which you evaluate the equity interests they take in the corporation, to determine if that's -- that they're paying specifically a fair price for it?

For example, a limitation on the amount of profit over a period of time, or a check after a year, or profits in excess of 50 percent after the first year of transfer must automatically rotate to the charitable trust, or anything like that?

I say that, because as I understand it, the evaluation technique is inherently imprecise, there's no way that it can be precise beforehand. And it's a situation, whether we like it or not, where the management people know more about it than you do, or anybody else in the world.

And so that there's at least a potential that they would derive a profit.

MR. TOM: Obviously, it's the case, Mr. Connelly, that when the buyout is by the management of the company, that there is an inherent conflict of interest. And if it were not for that, there may be no role for either the Attorney General or the Department of Corporations to legitimately play in the process of what would be in effect, the sale of a company, just as the sale of profit corporations goes on every day, without the intervention of a California agency.

But it is in recognition of the existence of this potential conflict that, in my view, legitimizes the role of both the Attorney General and ourselves at different points in time in this process.

Now, in evaluating the fair market value, I think theoretically, at least, there is no necessary reason to go beyond determining, you know, what is the operation, what are its assets, what are its earnings, earning power, what is its historical cash flow and so forth, and projections into the future in determining what fair market value is --

MR. CONNELLY: Do you ever do --

MR. TOM: But we do, in recognition of the management conflict potential, use a number of devices to address that concern.

MR. CONNELLY: But what I'm saying is that after you do all those devices, and maybe you won't acknowledge, but I think you acknowledge, after you do that evaluation technique, you could still be wrong.

MR. TOM: Oh, yes.

MR. CONNELLY: That's right. And that makes sense.

MR. TOM: Yes.

MR. CONNELLY: Then there's some procedures or rules that you've promulgated, whereby if an unreasonable profit occurs, in fact, you were wrong, that there's a bleed-off mechanism where that unreasonable profit goes to the charitable corporation.

MR. TOM: I'm not aware of any specific case in which we have designed a restriction or a requirement that some percentage of profits or dollar amount of profits, or anything like that, inure to the benefit of the foundation.

But we have done the following, which I think is reasonably proximate, and I think it actually has a lot of advantages to a system where we're trying to determine what's a reasonable profit and what's not a reasonable profit.

Number one, there have been cases, and we get to the foundation of case staudy. We will be addressing one of those cases, where substantially all of the value of the conversion was based upon the stock value, because that was the principal consideration that went into the charity.

So that to the extent the ongoing health care service plan becomes an extremely profitable operation, whether that's for the benefit of whomever or the stockholders of it, to the extent the foundation -- foundation was a poor choice of words -- to the extent the charity is the owner or partial owner of the health care service plan, it's going to get the benefit, and we'll see in Foundation, that that benefit amounted to tens of millions of dollars.

The other way we do it, another technique we use, is to restrict stock sales by the management insiders during the early period following conversion. And again, when we get to FHP, we can look at that a little bit more closely, because one of the conditions that was placed on the management purchasers of FHP's parent company was that they would be restricted in their sales of stock during the first two years following conversion.

MR. CONNELLY: I have a lot of questions about Foundation, but I'll save those. Let me just ask in a general vein, do you, as a matter of procedure, after a conversion, go back and in some fashion check to see, when the management's effected the purchase, what kind of profit they've made, or after a period of time --

MR. TOM: We --

MR. CONNELLY: -- in terms of exercising stock options, or direct equity interest, or bonus stocks, or any other consideration?

MR. TOM: Well, we would have, of course, continuing jurisdiction over the health plan as such --

MR. CONNELLY: Um-hmm.

MR. TOM: -- and therefore, would periodically be receiving informaiton and deriving information directly from our financial reviews and so forth, of the operations of the health care plan following conversion.

MR. CONNELLY: I'm not sure that's resposive. Maybe I didn't phrase it -- well, why don't you go on, maybe you're getting to it.

MR. TOM: Well, I was going to say that I think the focus of your attention was on what has management gained in the way of value from the ownership interest that it derived from the conversion.

MR. CONNELLY: Yeah.

MR. TOM: That is, the stock is now worth, you know, $10 million or something like that.

The problem is determining whether that increment of value has anything to do with what the value of the plan was at the time of conversion. When we value, we are valuing the non-profit entity. It may change substantially after that time --

MR. CONNELLY: Yeah.

MR. TOM: -- in value --

MR. CONNELLY: You've giving reasons why they might make an unreasonable profit and be justified, or what I would term an unreasonable profit.

But my question was, do you, as a matter of process, after a conversion, go back to look at the profit that's made by those folks, and make some quantification?

You know, let me just shake it down. I mean, what we're talking about is, we're talking about non-profit corporations that are charities, that the public or the people who are part of that, are entitled to full value. There's alleged deals that have occurred, where they have been sold to the management of those non-profit corporations, turning it into a profit-making corporation, which is fine.

I agree with Ross' comments on profit-making corporations in the health -- but as a part of that, because of the inherent conflict, they have made a sweet deal, right? And they're making more money than they should make in the effect of that transfer.

They're making what is an unreasonable profit, and when they're making an unreasonable profit in a short period of time, they are effectively stealing it from the charitable trust or from the customers or the foundation, as the case may be.

And yeah, my question is, do you, as a matter of procedure, after a conversion, go back after a period of time, and look at that transaction, to see whether or not in fact, those people make a big hunk of money, and whether or not it appeared to be reasonable in the circumstances.

MR. TOM: I don't intend to avoid answering your question. And I'll keep trying until I've adequately answered it.

MR. CONNELLY: All right.

MR. TOM: But my point, Mr. Connelly, is that if you're going to look after the fact at data, to determine whether the valuation was proper at the time that it was made, that's a legitimate --

MR. CONNELLY: Um-hmm.

MR. TOM: That's a legitimate inquiry. It's something that we would be interested in, that we should be doing, and do do.

If you mean, however, to measure the amount of management profit, for whatever reason it was derived by, in a vacuum, without saying that that has a necessary nexus to the value at the time you converted, in other words, that we converted it for the wrong value, then I don't think that's a legitimate question.

MR. CONNELLY: Let me -- it may be legitimate question, but it's one you're not seeking an answer to. I mean, that is the way I would phrase it.

MR. TOM: In my judgment, it is not a legitimate question, not a legitimate issue on the question of, did the Department of Corporations properly determine the fair market value at the time of conversion.

MR. CONNELLY: Okay. Mr. Tom, what I'm after, and I guess, let me try to phrase it in the way that you phrase it.

When we go back and look at this increased value that has occurred, versus the valuation you made at the time, and ignorning for a second who has acquired that equity, because it's in a trust, and sometimes it's a private party and what have you, how do those evaluations look?

Is there, are there incidents of conversions where there's more than 100 percent increase in value in the first year, as an example?

MR. TOM: Just in general, without having done any research on the hard data, my general assumption is that those people who acquired the shares of those companies that converted, say, a couple of years ago, we can really test what the change in the market value has been in that period of time, have done extremely well.

MR. CONNELLY: How do you --

MR. TOM: Because the market --

MR. CONNELLY: How do you --

MR. TOM: The market for HMO securities has been --

MR. CONNELLY: How do you define "extremely well"?

MR. TOM: I would --

CHAIRMAN McALISTER: Between 70 and 700 percent.

MR. TOM: Well, that may very well be the case --

(Laughter.)

MR. CONNELLY: Well, that's --

CHAIRMAN McALISTER: That's extremely well to me.

MR. CONNELLY: That's what I would call extremely well.

MR. TOM: It is to me, too, Mr. McAlister.

MR. CONNELLY: Let me -- can you quote on one piece of paper, there's the 20 conversions that have occurred, or the five that have occurred within the last 18 months, here's the evaluation we did, this iis what's happened as a practical matter to the stock in that 18-month period.

And then we can see one is 143 percent, the other is 70 percent, the other is 600 percent. Can that be done?

MR. TOM: Of course.

MR. CONNELLY: Well, maybe what we can do is just ask that that be done. I would like to see that.

That, of course, then, leads to the second question, which I guess you don't ask, as I understand your earlier answer, and that is, do the management people, have they shared in that growth, and in what way and in what dollar amounts and what percentages, as a result of that growth, within that time period.

And you don't ask that question. In other words, you look at the individual, that entity, and the valuation of that entity, and you can see the percentage increase.

But you don't ask the second question, as to whether or not these people that you characterize as having inherent conflict, have benefitted proportionately, or more than proportionally, in accordance with this growth.

MR. TOM: Well, they have clearly benefitted. I assume they benefitted proportionately, because the benefit we're talking about is based upon their stock ownership, and portion is, I assume, in proportion to other stockholders.

MR. CONNELLY: Alister said it extremely well, and he said 70 to 700 percent. Can I ask you to quantify that? What do you mean, extremely well? Seriously, I mean, what is --

MR. TOM: I'm afraid I cannot answer that --

MR. CONNELLY: Is it more than 100 percent?

MR. TOM: I'm sure in many cases it is far more than 100 percent.

MR. CONNELLY: If --

MR. TOM: Just based upon the stock action.

MR. CONNELLY: If it's more than 100 percent, and if people are profiting by that amount, does that raise questions in your mind that maybe the original valuation was not really a good one? That there's 100 percent growth or more, in a short period of time?

MR. TOM: Well, again, the question is whether we did a proper job of evaluation. And is a company is growing, you know, as is true, some companies, some of the health care plans that have converted, since their conversion, are growing at rates of 60 to 80 percent per annum.

MR. CONNELLY: Um-hmm.

MR. TOM: Which can be attributable to the fact that by converting, they are capable of growing at that rate. That that is a legitimate -- and let's assume those managers are making 1,000 percent --

MR. CONNELLY: No, we're not arguing about whether or not it's legitimate, we're arguing about your ability as a department to make a fair evaluation, and is it a fair evaluation when, in point of fact, if I'd know, quite candidly, that I could make 300 percent profit in a year, I would have paid, you know, the dollar -- I mean, I'm just really naive, and you understand, what I know about stocks, you could put in a thimble, it wouldn't sink.

But it seems to me that it's not a full evaluation, if you say it's worth a dollar, and you say selling it for a dollar to an insider is all right, when in point of fact, after a year, it's now worth three dollars, it seems to say maybe it wasn't a fair valuation.

And my questions is, if, A, you're doing that kind of analysis, which I guess you are, and B, you're coming up with these kind of figures, which are extraordinary profits, and then that leads me to the C, and that is, you know, what are you doing differently, and maybe you don't see a problem that's allowing that to occur, where we're not evaluating properly, because for 8,000 extrinsic reasons that we'll argue about the rest of the day.

MR. TOM: I don't --

CHAIRMAN McALISTER: Why don't --

MR. TOM: -- that I can satisfactorily --

CHAIRMAN McALISTER: No, there will be -- all these points will be covered --

MR. TOM: Certainly.

CHAIRMAN McALISTER: -- in detail. Mr. Johnson.

MR. JOHNSON: Mr. Chairman, I don't want to belabor the point, but it seems to me that the fact remains that in any transaction, whether it's a conversion from profit -- from non-profit to profit status, any sale of any product or a sale of any form of raw material, or whatever we're dealing with, there comes a point in time when a value has to be established.

And establishing a value, regardless of who is establishing that value, is going to be an inexact science. It cannot be an exact science. And to come along, 12, 18, 24 months after the fact, when conditions have changed, as a result of that conversion, and then attempt to evaluate the valuation, of you will, the price that was judged to be a fair price at the time of the conversion, it seems to me, is kind of a useless exercise.

We can talk about bleeding off mechanism, or whatever, if profits have increased. I don't think, however, we'd be interested in doing the reverse, that is to say, that if they lost money, that the charity that had received the benefits of that conversion at the time should repay to the for-profit corporation that's set up, the losses that they experienced over that period of time.

It just comes down to, you have to set a point in time where a value is established. And I guess my question to Mr. Tom is, do you agree with that?

(Laughter.)

CHAIRMAN McALISTER: I guess we'll be interested to find out if there have been any cases where these companies have decreased in value after the conversion, and whether this has happened --

MR. JOHNSON: You know, that's a remarkable argument, Mr. Chairman, for the purpose of the conversion in the first place, to get these out of the non-profit, out of government subsidies, and into the realm of a free and competitive market, where they have access to capital and can expand, and achieve the goal of this Legislature, which was to maximize competition, to maximize providing health care to the people of this state, at the lowest possible cost.

CHAIRMAN McALISTER: Well, Russ, aloong with that, the law says that the charity is supposed to be paid the value of the asset. I mean, the thing -- it's not because the charity is some third party out there just begging, I mean, that was the charity.

This is the organization, it's the one that's being converted. And if they give this thing away for but a portion of its true value, I mean, free market and competitive principles don't justify that.

MR. JOHNSON: But this --

CHAIRMAN McALISTER: Mr. Tom seems to be saying that somehow, the law on charitable trusts has been repealed, and he does this by a long, extenuated argument of implication upon implication, and I don't think the Knox-Keene Act did a thing to the law on charitable trusts, not a thing.

MR. JOHNSON: Mr. Chairman --

CHAIRMAN McALISTER: And the law of charitable trusts is one of the most powerful laws in the world. And it requires extreme fidelity by everybody, the fiduciaries, and everyone who's affected by it.

MR. TOM: Mr. Chairman, if I implied to you that we were attempting to repeal the law of charitable trusts, then I'd like to correct that impression. Because that is not our impression, and we take seriously our role as regulators, insofar as the determination of fair market value is concerned.

MR. ROBINSON: Yeah. Mr. Commissioner, though, you did say, in response to both Mr. Connelly's questions and once to Mr. Johnson, that if it wasn't for the insider nature of this transaction, the AG had no role.

And the law of charitable trusts is clearly in the domain of the Attorney General of this state.

You said that not once, but three times. I counted them.

CHAIRMAN McALISTER: What I said that was, if --

MR. ROBINSON: If there wasn't the insider nature of this transaction, there would be no role for your department, nor the Attorney General. You said it not once, but three times, sir.

CHAIRMAN McALISTER: In connection with the conversion. That's correct.

MR. ROBINSON: That implies the repeal of the law of charitable trusts.

CHAIRMAN McALISTER: Yes.

MR. ROBINSON: That's clearly within the domain of the Attorney General.

MR. TOM: But the premise was, if there were no insider transactions -- and there clearly is -- therefore, how could I have implied that we were repealing the law of charitable trusts? I don't understand that in the least.

CHAIRMAN McALISTER: Well, you, of course, don't have the power to repeal it --

MR. TOM: Nor the intention, I'd like to add --

CHAIRMAN McALISTER: -- but you apparently have the power to ignore it de facto.

MR. LANCASTER: Mr. Chairman?

CHAIRMAN McALISTER: Yes?

MR. LANCASTER: Mr. Chairman?

CHAIRMAN McALISTER: Mr. Lancaster.

MR. LANCASTER: Mr. Tom, the Legislature, in its wisdom, I guess, in '83, and effective in '84, made a determination that the Department of Corporations shall be the responsible agency as far as placing a value on these conversions. Is that correct?

MR. TOM: That's correct.

MR. LANCASTER: We did that, I presume, for the purpose of trying to eliminate the impediment that perhaps existed under the law at that time of these conversions, by having dual responsibility by two governmental entititles, the Attorney General and the Department of Corporations.

MR. TOM: That's correct.

MR. LANCASTER: Which leads me to my next question. These non-profit approaches were developed over many years, based upon the fact that governmental entities, whether they be federal or state, made a determination that they would assist in development of these non-profit groups, by various grants, aids, or whatever the case may be, that came through the normal governmental channels.

This source of ability or funding for the non-profit organizations simply has dried up. Government is not doing that any more.

So therefore, what we have now is a system where if these charitable, non-profit health care providers do not convert, they simply do not have the ability to fund ongoing expansion or resources or facilities, whatever the case may be, because there's no governmental money to any great extent available.

Is that what's happened out there? Is that's what caused a conversion?

MR. TOM: Yes, that's right. At least at the same price as their competitors in the for-profit sector can achieve it.

MR. LANCASTER: So when they convert to a profit, then automatically they are involved in ability to get investment, attract capital, all of these things that go with the profit sector, that they cannot do if they're not in the private sector. That's what it amounts to.

MR. TOM: Yes.

MR. LANCASTER: And so that's what's bringing about all these conversions. Okay. And this is happening because they just -- evidently are going to blow away and go away if they don't convert, because they're just simply not going to be able to exist if they don't have the ability to expand.

MR. TOM: Well, they certainly can't compete in a competitive market --

MR. LANCASTER: Yeah.

MR. TOM: -- like this, which requires the, you know, substantial capital facilities to keep an ongoing business.

MR. LANCASTER: The law passed in '83 said that your department is responsible for establishing a fair market value for the charity. Is that correct?

MR. TOM: Yes.

MR. LANCASTER: And in doing that, what you have done, in both these cases that we're talking about today, you have utilized the IRS approach to this, is that what you've done?

MR. TOM: Yes.

MR. LANCASTER: Which seems to be a standard approach utilized, I guess, by a lot of folks in this business. And so what you've done, you've gone -- you haven't determined the criterion, you've used the Internal Revenue criterion, is that correct?

MR. TOM: That's correct.

MR. LANCASTER: And that's how you establish the value.

MR. TOM: That's right.

MR. LANCASTER: Aside from that, under this one case, I guess the Orange County circumstance, that charitable group, and now that charity, not only did they receive a value of $38 million, according to the chronological thing, the very value, they also are shareholders, if I'm not mistaken, which is a part of the $38 million, in the profit corporation. Is that correct?

MR. TOM: Part of that --

MR. LANCASTER: Of the 38 million.

MR. TOM: -- (unintelligible) is due, is convertable under certain curcumstances into a percentage of the equity of the ongoing profit corporation.

MR. LANCASTER: Which means they have a sharing in the increased value of the stock.

MR. TOM: Yes.

MR. LANCASTER: The profit potential. They only have the potential of sharing.

MR. TOM: Have the potential of sharing. And in the Foundation situation that we will also be looking at, it was far more substantial than --

MR. LANCASTER: But they both are similar.

MR. TOM: The estimate of the value was based upon equity.

MR. LANCASTER: So that's what brought about the conversion is the need for capital, the need to create competition is basically, in other words, that need is there, and so consequently if they existed as a non-profit health operation, they frankly would not be able, for competitive reasons, with the profit -- and by the way, some of these groups that are trying to buy other groups, did they not convert?

MR. TOM: Oh, yes --

MR. LANCASTER: In other words, this one group, for example, that made an offer on the other group, is a group that converted, and then wanted to buy the other group that was not going to convert, so it couldn't convert.

It gets kind of interesting, doesn't it?

MR. TOM: Yes, that's correct. In the case that you're speaking of, the conversion took place in 1980, and the conversion took place at, I think, an approved -- a price that was approved by the Attorney General and the Department of Corporations. It was between three and $400,000. The company is worth hundreds of millions today.

MR. LANCASTER: In other words, since 1980 it had a huge growth, because they were available to attract capital.

But they're also trying to buy non-profit organizations, which is kind of interesting.

MR. TOM: Well -- yes.

MR. LANCASTER: Okay. Which is --

MR. TOM: As a matter of fact, their growth rate has been very exceptional, in order to justify that kind of a market --

MR. LANCASTER: And this was the one that was approved in 1980.

MR. TOM: Yes.

MR. LANCASTER: I see. The Attorney General has taken you to court, is that correct?

MR. TOM: Yes, that's correct.

MR. LANCASTER: And the courts have not ruled in their favor. Is that correct?

MR. TOM: Well, the action that was made was an action to secure an injunction against the Department --

MR. LANCASTER: And that was not granted?

MR. TOM: -- and FHP. And that was not granted by the court, that's correct.

MR. LANCASTER: Thank you, Mr. Tom.

CHAIRMAN McALISTER: I think it must be pointed out that what has happened thus far in the courts cannot be cited as precedent for anything. It was an action, there was a very limited ruling made upon a request for a temporary restraining order, was in effect what it was.

And the court decided that it didn't need to do that, that the action would proceed, and that the defendant was well able to respond in damages, if any cause of action were established.

MR. ROBINSON: (Inaudible.)

CHAIRMAN McALISTER: Yeah, I know. But I think it's a serious error to cite that case as establishing anything, aside from the fact that it's only a Superior Court --

MR. JOHNSON: An OSC --

CHAIRMAN McALISTER: -- decision that's in the very early stages of a case.

MR. TOM: There's one additional --

MR. ROBINSON: What's the issue without this --

MR. TOM: What?

MR. ROBINSON: Did they issue an order to show cause? I mean, it's still active before the Superior Court --

MR. TOM: There was -- I don't remember the exact technical -- I got before the court, but they were asking for a preliminary injunction, and the court denied the preliminary injunction, on rather narrow grounds, actually.

MR. ROBINSON: I have a follow-up --

UNIDENTIFIED: I don't believe they have --

MR. TOM: Well, you don't appeal it, you go into trial.

I mean, that's what you would do. And whether they're going to trial, I don't know. They can tell us later.

MR. ROBINSON: Mr. Chairman, I have a question, through you to your staff --

CHAIRMAN McALISTER: Yeah.

MR. ROBINSON: Is there a difference between the AICPA standard for evaluation and the IRS? I believe there probably is, and --

CHAIRMAN McALISTER: I didn't hear the question, Mr. Robinson.

MR. ROBINSON: If there's a difference the AICPA, the American Institute of Certified Public Accountants standard for evaluation, and the IRS.

The IRS tends to operate outside of the logical system on accounting.

(Laughter.)

MR. ROBINSON: Some say that accountants operate outside of a logical system of reality --

UNIDENTIFIED: You're talking as an accountant, and I --

(Laughter.)

UNIDENTIFIED: The Commission is not one, but --

MR. ROBINSON: They only did that, but that's what whatever they say goes.

I'm not a lawyer. The other question of the staff, Mr. Chairman, is, it seems to me there's analogy that exists between the Securities and Exchange Commission and the Federal Home Loan Bank Board's regs and controls over the exchange of a mutual savings and loan to a stock corporation, where we have not had these type of problems, or these types of attacks.

I would like to see a comparison of -- and there's been some recent ones in California -- and know how the federal law has acts (sic) to prohibit, or to impede this type of profit making.

CHAIRMAN McALISTER: Well, we'll hear, incidentallly, later today from folks who are CPA's who perhaps can tell us about these things.

MR. ROBINSON: Yeah, I know. But there's a federal -- the Securities and Exchange Commission has very stringent -- inside of -- you know, a mutual savings and loan, with the management, in essence, in control of the whole operation, when they go to stock corporations, SEC has stringent requirements that have to be met, together with the Federal Home Loan Bank Board, and the Federal Insurance Deposit Corporation, and there are auditors all over that place, and they haven't had problems like this.

Nobody's suggested a 700 percent profit margin. And those stocks go on the stock exchange, and it's all part of the documents.

And it seems to me it's an analogous situation, while it's not a charitable trust, under the federal law, it's a mutual corporation where every depositor is in fact an owner of the company, to a stock corporation.

And the depositors -- and there's a whole procedure for the offerors, and everything. It's been so long since I've looked at one of those. But it's an analogous situations, with the exception that you're talking, as Mr. Johnson so artfully put it, a governmentally subsidized operation, and I'm just interested in owners' equity, since we've been subsidizing it.

CHAIRMAN McALISTER: All right. I appreciate your participation, Commissioner. I think we ought to go on to the Department of Justice right now.

MR. TOM: Thank you.

CHAIRMAN McALISTER: Since we're already running behind. Will the Department of Justice come forward.

MS. ORDIN: We'll get our water first.

CHAIRMAN McALISTER: Yes.

MS. ORDIN: Good morning, Mr. Chairman. I'm Andrea Ordin, chief of the public rights division of the Department of Justice. Member Johnson has commmented on the antitrust implications.

The public rights division not only has the charitable trust section within its jurisdiction, but also the antitrust section. So I have the fortunate opportunity to supervise both sides of that issue.

I have with me James Schwartz, who is a Deputy Attorney General from San Francisco, who has been primarily responsible in this last for our involvement in these issues.

The summary that you have already received, each of you as members, and that has been passed out, of the historical chronology of the Attorney General's jurisdiction and involvement, I think, is quite accurate.

Commissioner Tom has also gone through that historical summary, and again, I think, quite accurately.

We originally thought we were going to be out of the business in 1975, when the Legislature first enacted the Knox-Keene Act, becuase, of course, as you all know, it transferred primary regulatory authority from the AG to the Department of Corporations.

As many of you also remember, in 1976, in the course of an investigation by the Governor and the Little Hoover Commission, it was determined that more than 40 percent of the prepaid health plans holding State MediCal contracts were organized as non-profit charitable corporations, and therefore subject to our jurisdiction.

There were many problems during that area (sic), some of them sound very much like the problems that we're trying to address here. But from 1976 to 1979, the AG's Office conducted numerous audits, conducted enforcement actions, resulted in substantial monetary recoveries of diverted MediCal funds.

Then, effective in 1980, the next kind of timeline that I think is important to us, the Legislature did make another significant change in the law, and eliminated the strict trust law standards previously applicable to charitable corporations, in Civil Code Section 2229.

But it did, while it cut back there, it did create new standards permitting self-dealing, but only subject to certain safeguards designed to protect the charitable assets against diversion throught insider profiteering.

And that's Corporations Code Section 5233(a) through (d). As you will hear at the end of my remarks, and as we'll discuss, I assume, this afternoon, there are differences between the Department of Corporations and our office, on just exactly what Section 5233(a) through (d) means, which portions of that section are applicable to the conversions that are before us today. And a Superior Court judge, as you have talked about earlier, has made one decision, and we still take another.

In any event, since January 1, 1980, since, indeed, Corporations had the primary responsibility for policing HMO's, and enforcing the Corporations Code provisions, since all statutory reporting was to Corporations, it basically became Corporations' jurisdiction.

That, as often happens, there seemed to be still some glitch. And that glitch was, the statutory overlap between the AG and the Department of Corporations, because of Corporations Code 58135, which still required the AG to approve for the conversion of any public benefit corportion, to for-profit or mutual benefit status, and no exception was made for HMO's.

We did think that was an oversight, Corporations thought it was an oversight, since everything else's was lodged in Corporations.

So basically the determination was made, a kind of Treaty of Ghent, I guess, that we would defer to the Department of Corporations in this regard, and would approve conversions only after the Department of Corporations had previously agreed in writing to the propriety and valuation of the conversion, and its compliance with all Knox-Keene Act requirements.

Under that -- treaty, the Department of Corporations forwarded to us perhaps a dozen conversions for us to sign off. And we did so, consistent with that policy decision.

In '83, the reality of this signoff provision became apparent, and since all of the other functions seemed to be in the Department of Corporations, we proposed, as Franklin Tom has indicated to you, to the State Bar Committe on non-profit corporations, that that remaining provision be deleted, since in fact we were no independently auditing, we were not independently looking at it. That there was no reason to have that provision still there.

In 1983, Corporations Code 10821 was enacted to do just that. That seemed to be the end of the Attorney General's involvement in this area. But in September of '85, the Attorney General was served with a complaint in the case of Maxicare v. Gumbiner (phonetic) in the Los Angeles Superior Court.

We were made a defendant in that case. Maxicare, the plaintiff, who wished to acquire the FHP, sued us and the

Department of Corporations. So just to correct the record sightly, that lawsuit was not one in which the Attorney General sued the Department of Corporations. We have been brought in as a defendant. And then took our independent position there. And our independent position, as you all know, was after inquiry. We looked and we saw, one, that the proposed conversion was without the written approval of the Attorney General.

Even though we had a 1977 settlement agreement with HFP, Inc. in the case of People v. Gumbiner. which specifically required their coming to the Attorney General for approval in any future self-dealing. So we believed, and do still do believe we had a contractual right with Gumbiner to come to us. Two, we found out and looked and thought that in fact FHP had not complied with the Corporations Code 5233(d). Which we say is the standard.

That is basically that, if you are self-dealing, you still have to get the best deal in town. And then, finally, our independent analysis told us that the buyout price was remarkably low. When compared to what we believed was the likely market value. So, that's why we were in the lawsuit. And that, in answer to the Chair's question, is why we were in superior court.

We made those positions clear to the court. The court agreed with us on some issues. They agreed we retained charitable trust jurisdiction. Not only because of the contract, but because of our common law and statutory powers. That the law of charitable trust has not been repealed. And we have powers and duties to be there.

They did not agree that it was an appropriate case for a temporary or preliminary injunction. But that under our power -- our common law and statutory powers that we should procede in damages of -- against the defendant if we thought that was appropriate. Expressed in the record that there were some concerns about valuation. But disagreed with us also that the (d) provision of section 5233 was applicable.

And said it was only (b). A kind of fair market value assessment. Not the very best deal in town. Our view is that it is (d). And it is something that ought to be addressed by this Legislature. It is further our view in that lawsuit that even if it is (b), that the standard of fair market value was not met in that particular case. And that's why we're still in litigation.

I would like to say that it is not our position that it is an auction. That you have to take the best bid no matter who it comes from. Whether it's a competitor or not a competitor. But charity must be fairly treated. That the Knox-Keene Act did not repeal the charitable trust laws. And that's why we're in litigation.

CHAIRMAN McALISTER: All right. Thank you. Mr. Connelly?

MR. CONNELLY: Have you looked at any other conversions other than this one?

MS. ORDIN: Since the news has hit on Foundation, we are of course looking at that, too. We had not independently been looking at any of them before that time.

MR. CONNELLY: Are you able to provide information about Foundation? Or are you just starting to get into that? Where are you?

MS. ORDIN: We're just starting.

MR. CONNELLY: And just so I understand it. You're going to continue, or the AG intends to continue the litigation pattern on what criteria is to be used in the valuation?

MS. ORDIN: Yes. And, factually on this case as well.

MR. CONNELLY: I see. Thank you.

CHAIRMAN McALISTER: Lancaster.

MR. LANCASTER: Clarification of a point. There was a treaty you had for a while with the Department of Corporations. Because the determination was made by both agencies, I guess, that the law was clear there was an oversight in not accomplishing. Did I understand you to say, though, in the '83 legislation as far as your jurisdiction -- other than your normal common law responsibilities -- as far as conversion was eliminated is that correct?

MS. ORDIN: That's right. That was right. We did not have to do that sign-off as well. Which was done in a somewhat cursory manner.

MR. LANCASTER: Okay. So, therefore, you are now out of the picture other than your normal responsibility as far as the

Attorney General's office is concerned?

MS. ORDIN: That's right.

MR. LANCASTER: By law?

MS. ORDIN: Yeah. That's right. But -- and, you know, there would be those who argued then you're normal responsibilities tend to be somewhat coextensive. But, at least, we're not in the regulatory phase of --

MR. LANCASTER: We're now in the nonadministrative of it. You don't have to sign this off --

MS. ORDIN: That's right.

MR. LANCASTER: -- you don't review these things. In other words?

MS. ORDIN: That's right.

MR. LANCASTER: Okay. Thank you.

CHAIRMAN McALISTER: That is, they have general jurisdiction over charitable trusts. At any time they think a charitable trust is being abused they have the duty and the obligation to do something about it?

MS. ORDIN: That's right.

CHAIRMAN McALISTER: Okay. Any other questions? All right. Thank you.

MS. ORDIN: Thank you very much.

CHAIRMAN McALISTER: Now, we go to respectives on determining value of a business conversion. Mr. Thomas L. Kelly, partner Peete, Marwick, Mitchell & Co. Go ahead, sir.

MR. KELLY: Mr. Chairman, Committeepersons, happy to be here today to talk a little bit about business valuations. Particulary because of the favorably comments I just heard about accounts. It's relatively unusual.

UNIDINTIFIED: You didn't hear that from the Department of Corporations. You hear them from me.

UNIDINTIFIED: You just heard it from one member.

MR. KELLY: I am a partner in the Los Angeles of Peete, Marwick, Mitchell. I specialize in health care. And have been involved in business valuations and a variety of other services to health care organizations for the past 13 years. What I'd like to do over the next few minutes is review the conventional business valuation techniques with you. And to lead into a discussion by Mary Tanner of Lehman Brothers about how you choose among those techniques in performing a business valuation.

I think it's fair to say that the types of business valuations that were enumerated by Commissioner Tom are the typical types of valuations applied, really, by both accountants and in tax circumstances. So. And briefly what I'd to describe three of those. The first is asset valuations in which an individual appraisal of specific assets is made to determine the value of business.

And again that would be where -- in a business which was asset bound. And it which inventories, plant, and equipment had substantial value and were the main contributor to business value. Important to all these types of valuations - or the key assumptions which underlie them. And that's -- we'll try and identify in each of the valuation approaches those assumptions which will typically affect the ending valuation value most significantly.

Key assumptions in the asset valuation area. What are the replacement costs of those assets? What size of the market is there for those assets? Is it a large market? Is it a small market? And can the assets be converted to alternative uses? So we -- you'd go through a process of, in fact, adjusting the book value of the corporation to reflect the current value of all the assets held. And, typically, in the inventory in the plant area where you see the most sizeable writeups in value.

The second generic valuation technique that we'd like to discuss are earnings multiples. And this is used to by by accountants in valuations in valuation techniques. But not typically by the IRS. And the earnings multiple technique is to identify publicly traded companies in the same or highly similar businesses. Develop an earnings per share multiple that they enjoy in the market. And to apply that multiple to historical or expected company earnings.

This, certainly, is an area where there is a high amount of volitility currently in the HMO business. And there's be a great change, I'd say, over the past 24 months in how the market regards HMO earnings. And the market, here, is viewed as the best determinate of the potential risks and the potential growth for that type of business. The key assumptions would be the comparability of companies that you can select to make that earnings per share multiple comparison.

The choice of the earnings measure, again very critical whether you chose historical earnings or expected future earnings. This is a -- this becomes particularily problematic where you have a startup enterprise that may have sustained loses over several years. But is starting to enjoy earnings and earnings growth. And you have to make a judgement as to whether that historical set of earnings is more appropriate or a future set of earnings is more appropriate to set the value.

The value -- in the earnings multiples approach the value of tangible assets is really not significant to the overall company value. Although it may somewhat affect it. And here the assumption, again, is that the market is relatively efficient and knowledgeable. And that, therefore, it's a good predictor of future value.

The final valuation technique I'd like to talk about is discounted cash flow. And really the multiple of retained earnings approach is a subset of this discounted cash flow technique. The discounted cash flow technique says that a value of a company equals the value of its future cash flows that it'll generate. And if you look at it from a practical standpoint, what you're going to do is value some numbers of years earnings into the future. And then set some terminal value on the company at the end of that earnings stream.

Typically, a five-year pattern is used to look at what the future earnings growth will be. Assuming that at that point in time earnings growth stabilizes and that you can set a value on the company at that point in time. Again the key assumptions of the choice of historical versus future earnings. And this is going to have a very significant impact on the total valuation.

Secondly, if you are to use historical earnings, whether you carve out nonrecurring costs. Their development costs. Initial marketing costs. Initial organization costs reflected in those past years earnings that would affect -- could affect significantly the valuation.

The third key assumption is the potential for growth. And certainly if you look at you HMO multiples today, much of what's reflected there is an expectation of very subtantial future growth. And growth on the order of 100 to 100 percent in numbers of enrollees or in revenues. Not on 10 to 20 percent. So that -- so that expectation about growth which is built upon a knowledge of the market in which a company operates. It's an ability to move into other markets is going to have a very significant impact on the ending value.

And, finally, what's a reasonable expectation of a rate of return? And that rate of return assumption is a combination of how much risk is there that that growth will be achieved. And, two, what's a reasonable reward for invested monies to begin with?

Probably the hardest part of valuations is to try and begin to view the difference between what I say is value and price. And it certainly has something to do with this controversy as well as many others in the market. And at least for an accountant, value and price are terms with different meanings. And if we go back to the IRS definition, where you talk about an exchange between a buyer and a seller each potential buyer brings to an exchange an expectation of a company's contribution to it.

Which is different from that company standing alone. There are a variety of reasons for that. A purchaser that needs senior management talent, for example, would often pay a premium over what we might say is value for a company. Just to obtain that talent. A purchaser with access to capital. Or with related businesses that can benefit from the acquisition, again, might pay a premium over what we'd call the value of the company.

And finally, a purchaser -- and this in particular for a public company -- whose own market value is dependent upon the achievement of growth is often willing to pay a premium for an alternative that will achieve that growth relatively quickly. So all those things will lead to differentials between what I'd say is a market price that gets set out in the economy. Which an individual purchaser, or even several, may be willing to pay. And what the underlying value of the company is.

Mary Tanner from Lehman Brothers will continue to talk about how you choose among these valuation techniques. You will find in practice that each type of valuation technique will yield a very different overall valuation of a company. And that as a result, and I think it's been mentioned already this morning, it is a very judgmental process. Both to choose the more appropriate valuation techniqued. To use the information garnered from the other valuation techniques to affect that.

And finally to set assumptions which are reasonable. Given the very specific market circumstances a company finds itself in. And the assumptions in many cases are at least as important as the valuation technique that's selected. Having said that, I'm certainly available for questions. Or we'll turn it over to Mary to talk about.

MR. ROBINSON: Mr. Chairman, I just have one quick question.

CHAIRMAN McALISTER: Yes, Mr. Robinson.

MR. ROBINSON: Using -- going back to your -- before you got into the nonIRS standards, earnings multiple, and whatnot. How would the previous witness, the Department of Corporations rather, testified that they used IRS standards. What would those be as it relates to good will and other -- the other nontangible assets as the corporation?

MR. KELLY: Well, presumably the goodwill or the intangible value of a corporation is reflected in its earnings stream. So that in using a --

MR. ROBINSON: And the IRS would use the earnings stream, then.

MR. KELLY: Um-hmm.

MR. ROBINSON: Historical earnings strength.

MR. KELLY: Yes.

MR. ROBINSON: Five years normal?

MR. KELLY: Five years is a normal pattern. Depending upon the history of the company and how long it's been in business.

MR. ROBINSON: Okay. Thank you.

CHAIRMAN McALISTER: All right. Thank you.

MR. LANCASTER: Mr. Chairman?

CHAIRMAN McALISTER: Yes.

MR. LANCASTER: In the case of nonprofit organization there is no earnings strength.

MR. KELLY: There is a --

MR. LANCASTER: What would be the earning strength of a nonprofit --

MR. KELLY: Accumulation of a net --

MR. LANCASTER: Assets.

MR. KELLY: -- capital. Sure. Net assets.

MR. LANCASTER: In other words, whatever you've got in the bank. And whatever you actually own. But that --

MR. KELLY: Yeah, they do have net income from year to year.

MR. LANCASTER: Yeah.

MR. KELLY: If you were to look at most of the nonprofit health care organizations they do achieve a net income for the year. Which is similar to the net income earned by a proprietary organization. Except for the fact that it's not subject to tax. And --

MR. LANCASTER: Okay. So, therefore, there is a relationship. And so that's what I'm trying to bring out.

MR. KELLY: Sure.

MR. LANCASTER: They do have an earnings strength. IRS rates book at that.

MR. KELLY: Um-hmm.

MR. LANCASTER: In effect.

MR. KELLY: Yes, they do.

MR. LANCASTER: As you would in a private situation?

MR. KELLY: Absolutely.

CHAIRMAN McALISTER: All right. Ms. Tanner?

MS. TANNER: Mr. Chairman and members of the Committee. I'm a managing director of Sherson-Lehman Brothers, Inc. which is an investment banking firm headquartered in New York. It's a subsidiary of American Express. I've spent about eight years in corporate finance at Sherson-Lehman. And prior to that five years in commercial banking in venture capital. Most of my present practice relates to health care and high technology industries. As a result of which I spend a lot of time in your town, even if I don't live here. Or in San Francisco, more properly.

Tom has discussed the various methods of valuation. And I think it was a very good summary, indeed. As he indicated, these methodologies can produce widely differing valuations. So

I think it's important to focus on the circumstances in which various techniques are appropriate. And in choosing the appropriateness of a particular methodology two things come first to mind.

The first is that one needs to define the objective of the valuation. And the second is that one needs to determine what action will be taken to actually realize the value. And what do I mean by the objective of a valuation? I think that question, frankly, is very much to the point in the case before you. Most people who engage my firm to provide valuation advice to them give us an objective.

That objective may be simply to raise additional capital to grow the business. It may be to maximize the value in whatever manner that is best achieved. It may be to bring a business public. So, defining the objective and having a clear sense of what you're trying to accomplish is very important.

Similarily, valuation posits an action to realize the value. For example, when you talk about liquidation value -- something Tom mentionied earlier -- a liquidation value, fundamentally assumes that the liquidator is going to sell the assets of the business in generally a fairly rapid fashion. In other words, the business will no longer be going concern that will grow year to year.

Alternatively, someone might say that to realize certain values you're going to take a business public. Which happens frequently in your technology industries in Silicon

Valley. Sell the business to someone else. Invest additional funds in the business. The nature of the action in large part determines the kind of valuation methodology and the level of value.

And I've used a word "going concern." What does that mean? Well it's a fairly important concept in valuation. It means the business operating as it normally does in its current competitive environment. Making long term as well as short term decisions regarding investment in factories, in people, in business areas.

There is another way to look at valuation. Which revolves around the concept of control. And that is at issue here in your discussions regarding the Orange County situation. Control means the sale of the business itself. Not the sale of a piece of the business. In other words, not the sale of 100 shares in the stock of a company. But the sale of 100 percent of its shares.

Therefore, we always very strictly distinguish in considering valuations between market value of a going concern and transfer value. Or the value of selling a controlling interest or all of the equity interest in a company. So, for example, in a market value setting it would be as if you called up your broker and asked to by 100 shares in American Express. How would you do your valuation?

Well, to determine whether you thought that was a good investment you would consider other comparable companies and where there stocks are selling. What Mr. Kelly suggested is the price-earnings multiple of historical earnings analysis of comparable companies to the particular situation you're valuing. You also might use a discounted cash flow. But of a very specific sort. And that would be, for example, what will the stock price appreciation be and what will my divided stream be.

Now in a transfer value situation we're talking about not the value of 100 shares but a value of 100 percent of the shares. There is generally a premium paid for control of the business. And why is that? Well, Mr. Kelly suggested a number of reasons. For example, a very frequent analysis our corporate clients ask us to help them in is whether I should buy or build a particular business.

Can I go buy a business to achieve my competitive objectives? Or should I build it from scratch by hiring people and having them go out and do it? Clearly there is a premium sometimes for the competitive and time value of buying rather then building.

Now, in a transfer value circumstance -- and I would suggest that the Orange County case is perhaps is one of those -- the two most frequent methods of analysis are discounted cash flow and an analysis of comparable transactions that may have occured in recent periods of time. Where markets and business conditions are comparable.

Now, in considering discounted cash flow, which is the most widely used method by private corporations when they do purchase control of businesses. It is important to recognize, as Mr. Kelly suggested that the answer can be different for different people. For example, a corporation buying a business which is very similar to its own may have tremendous combination savings. And, therefore, the inputs to his discounted cash flow model would be different that yours or mine.

And he'd be willing to pay a higher price. One thing that is important to recognize about discounted cash flow is that it's sort of like any analysis. Garbage in, garbage out. You have to be very careful that you give real care and thought to the data which you are using for your analysis. That the assumptions are realistic. That they are achievable in the timeframe suggested.

And I'd posit to you that one of the most important aspects of determining whether the basic business projections are reasonable that are being used in the valuation involves an analysis of management. The skills of management. How good are they. The value of management in businesses is proven every single day. And, in fact, for those of you who enjoy reading the financial pages of the newspaper where there's a considerable debate going on about takeovers. And the use of junk bonds in takeovers and so forth.

Hidden underneath and in between the lines of that debate very frequently is the real question of whether management has done a good job for the shareholders. And done the best job possible in the competitive circumstances. So, perhaps in your discussions regarding the issue of insiders it is important to realize that the value of management is not an insignificant thing. But it is very, very difficult to quantify in considering the valuation of a business.

So, I think, in conclusion while this is a topic that I basically earn my bread and butter on every day. And one could go on for quite a while. There's no analytical model that produces the value that is appropriate in a particular circumstance. Certainly in the sale of control of the business. Discounted cash flow. And a review of comparable transactions are perhaps more appropriate than the analysis of, for example, the price-earnings multiple or public market valuation of similar businesses.

Because that valuation reflects shareholders' expectations of what they're going to make on 100 shares that they own. In terms of stock price and dividend depreciation. It is very important to be clear as to the objectives that you are trying to achieve in valuing a business. And then acting to realize that value. And there are many valid objectives.

Frequently our clients or venture capitalists who have invested in a business and ask us to sell that business to a larger enterprise to specify, for example, that maximization of value is not necessarily the only objective. That preservation of the business environment or attention to the management which has been loyal and produced a valuable asset for them to sell are important circumstances.

CHAIRMAN McALISTER: All right. Thank you. Any questions?

Thank you, very much. Appreciate your participation.

MS. TANNER: My pleasure. Thank you.

CHAIRMAN McALISTER: We will go now to Bruce Bunner, Commissioner of the Department of Insurance.

(Pause.)

MR. BUNNER: Mr. Chairman and members of the Committee, we're delighted to be here today and share with you valuation type issues. Particularily as we are confronted with them within the Department of Insurance. I think in the outset I don't think we have a situation directly on point. In that hospital service plans or not for profit entities within the Insurance Code and there's no provision for conversion within the Code.

So we are not really confronted with the problem. Haven't been confronted with the problem. And will not be confronted with the problem. Unless we have some sort of legislative change, you know, permitting that type of a transition. I suspect the closest thing we have that might meet that sort of scenario would be the conversions under the sections of the Code for mutual companies to stock companies.

I think the other thing to emphasize is, you know, our emphasis is really with respect to the policy holders. And quite often where we are involved in situation where valuation is an issue, particularly with respect to the equity holders, you know, we're preempted under the Williams act. You know from really injecting ourself into that particular area.

So, when when we do get into these kinds of issues, they tend to be a little more subjective. And the Code does provide for, you know, us direct our attention towards antitrust type issues. And the competence, integrity, if you will, of the continuing management or the acquiror. And the financial condition of the acquiror. So that we don't run into some future, you know, financial type disaster or debacle.

So those kind of things we do focus on. So, quite often where we've had some typical acquistion mergers and type arrangements in the area of leveraged buyouts as an example. And in these kinds of issues I just mentioned are typically the things we focus on as opposed to the price of the acquisition between the buyer and the seller, if you will.

So, I think, for the most part the valuation issues that we're confronted with come in the context of our activities and the conservation or liquidation of insurance companies. And usually when we're in that particular scenario we're in, you know, a distress type situation. And, maybe, as you suggested in your memo to me that I might give some examples. And particularily the CalFarm situation that recently went to insolvency several months ago.

Just by way of background. CalFarm has been a company that's been around since almost the turn of the century. And was basically organized to serve the needs of the farming community within the state. About a year and a half ago they moved into a whole different class of business which was financial guarantees. And within about a six to nine month period proceeded to, you know, to totally destroy the company through the over exposure and the mismanagement of that particular product.

So, as a result, the Department had to move for conservation. And within that environment we were trying to come up with some sort of a workout plan in order to preserve or realize the most that we can of those particular assets. And the scenario basically went like this. We approached people within the industry as to what their interest might be in acquiring the good portion of that business. Which has typically been the business that's been around for the last 50 or 60 years. Which was, you know, the personal lines and homeowners and automobile type business with respect to the farmers.

And in a sense separate out the financial guarantee part of the problem. Which was really the cancer in that particular situation. One company did step forward and made a proposal. And on some basis how they would proceed to establish some values for those assets and liabilities that would be transfered in that environment. We tentatively agreed with that. It that were the best we could find within the marketplace. Although we were basically dissatisfied with it.

But we did agree to go to court with that particular scenario. In the meantime, because of our dissatisfaction we approached a number of other companies within the industry and asked them to competitively bid on that particular -- on this particular company. Then we were successful in stimulating interest with about five companies. Which ultimately came down to two. And we finally got into a court situation.

And they had different reasons for why they would seek acquiring these assets and liabilities, if you will. In one case it was a major insurer who was just sort of wanting to keep other competitors out of the marketplace. Which wasn't a legitimate reason. But in other cases that was very clearly a situation where two of these companies wanted to expand their operations within the state. And they saw some compliment with respect to this -- if we could maintain an on-going operations with CalFarm.

So, in essence, we, you know, worked out a work-out plan if you will. And we went to court with that. And, I think, in most cases and I think in every case that I've been involved with with the Department. When we've gone into a court situation it's always been in the context of a competitive type bidding environment. And we always reserve the right as to which one of those competitive bids we would recommend for approval.

The approach that we typically take we consider most of the things that have been presented here. Particularly by Peete Marwick and the people. Essentially the starting point is our own statutory accounting. We typically convert that to a gap basis. And then from there translate into what we would say is an economic, financial condition of the company.

And to get to the economic condition we'd deal with such issues bringing the assets to market values. In the CalFarm situation, it was going out for appraisals on the real estate that they owned. And getting appropriate quotations as to what the market value of the bonds were. They were the two principal adjustments. And the liability side was having actuaries basically validate the loss reserves.

And then computing the time value of (unintelligible) of those loss reserves in order to develop an economic surplus. And, to me, that was sort of a beginning point for any type of offer that might come in for the value of that company. Now the intangibles that are there, and I think these are some of the things that other people making presentations this morning were focusing on. And there's no, you know, strict way to follow these things.

But some of the issues that are there are, you know, the agency force. I think the company that finally did acquire the CalFarm situation certainly did look for the agency force. And the savings that will be involved in that process (unintelligible) trying to develop that throughout the state. Also with respect to the in force business that was there. And with some of the future profits were there. With some modifications as to how they were to market that.d

And, certainly, with charter rights with respect to the companies. And I guess there there's a number of other things. Would be litigation. Tax type issues. Operating loss carry forwards. And this sort of thing. We started out with sort of like a minimum bid had to somewhere between $20 and $25 million.

We did get into the court setting in the bidding. And the bidding was worked up to something like $55 million.

So, in that sense it was very successful. At least in our mind. Our opinion. Handling of that particular problem company. We've raised a considerable amount of money which allows us -- that will allow us to ultimately to settle the financial guarantee business on a much greater basis. Hopefully somewhere around 70 to 75 cents on the dollar as opposed to what might have been about five or ten cents on the dollar.

Have a similar situation. We currently have in conservation the Mission Insurance, which received a lot of publicity. And the same kind of issues are basically here. We've basically agreed in principal as to a workout plan. Subject to a lot of conditions. A lot of hurdles still to overcome. But, in one sense, we took the same approach. And as to the business that we will transfer to another operating entity. And making those kind of valuation adjustments. And saying, you know, this is the minimum that we would consider. And then kind of going forward from there.

I guess I don't know what more to add other than these are the kinds of problems that we've been faced with.

CHAIRMAN McALISTER: Well, we appreciate that. Mr. Johnson.

MR. JOHNSON: Yeah. Have you -- you've cited examples of where you've used, in effect, a bidding process and with success. Have there been examples where companies have gone under in California -- companies which you regulate -- because your Department was involved in setting or attempting to set values in effect go to a bidding process for all or part of an operation. And as a result of those negotiations the entire business went down and there was no buyout?

MR. BUNNER: Well, I can't think of any specific situation where we've gone through this process and that it subsequently failed. I think we can think of some situations where we've had buyouts, if you will, and they perhaps they have not lived up to their expectations. And I think, you know, Mission Insurance is a good on in point. If you want to go back to that one.

A white knight came in, something like three or four years ago, and in order to take over from a tender offer that was being made. And a considerable sum of money was paid at that point in time. And I think they, in retrospect, they wished they could have avoided that whole situation. Because several hundreds of millions of dollars have been involved in that transaction.

I think Ticor is another example which is a problem company for the moment. You know, Southern Pacific acquired them a number of years ago. And I don't think that lived up to their expectations. And their whole scenario and synergy of what they were trying to do in their corporate environment. What we try to do in some of these buyouts is particularily to be concerned with the leverage type problems that come into play.

And then we get into the financial stability and looking ahead. So we have some internal policies. Even though it's not, in a sense, provided for or if there were any guidelines within the Code. And, basically, we're saying that we don't want anyone or let anyone acquire a company if the future projections would demonstrate that they'd have to bootstrap that particular acquisition.

MR. JOHNSON: Yeah. Isn't that a problem, generally, around the country. With all of the --

MR. BUNNER: Well, that is a problem.

MR. JOHNSON: Not just in the insurance field. But in business generally with the trend toward corporate takeovers. Mergers of one kind or another that --

MR. BUNNER: Sure.

MR. JOHNSON: -- bidding gets into an escalation so that the business after the fact may not really be worth the effort that was gone through. That the business may be so saddled with debt as to not be an economically viable institution?

MR. BUNNER: Right. That's the kind of problems you can run into. We've been particularily sensitive to it. And I can think of one situation where debt to equity ratio was something like 300 percent -- 300 to 1. And, obviously, that was a very extreme situation. In our mind we disallowed it, you know, primarily because we couldn't see any way they could support that kind of debt service without, in a sense, throwing money out of the insurance environment.

So that brings us back to the focus where it belongs. At least in our environment is the policy holders that we've, you know, somehow jeopardized their situation.

MR. JOHNSON: In other words, you're saying it comes down to a policy judgement as to the public need that has to be met there. And a balancing of that public need. The bidding process, if you will, on the one hand. The maximizing the dollar amount. But the flip side of that trying to protect the policy holders as well. And maintain that level of protection.

MR. BUNNER: Well, that's right. And it becomes subjective. And -- or policy type issues. And, I guess, you can always second guess those as to whether you made the appropriate decision or not. But we do in fact have those guidelines.

MR. JOHNSON: Thank you.

MR. BUNNER: And we apply them.

CHAIRMAN McALISTER: Mr. Robinson.

MR. ROBINSON: Mr. Bunner, let me. I understand the analogy from the standpoint of your office representing the policy holders. And corporations and AG in theory representing the beneficiaries of the charitable trust. But doesn't the analogy fail, though, when you look at that you're dealing with basically bad companies. And under the conservatorship and the conservatorship setting. And therefore, whatever analogy you want to draw on the management of those companies would be there. And where the situation's coming before the Committee, Mr. Johnson, you're dealing with the very viable institutions that want to grow. And don't have the, either the black mark on the market place. And they have a presumable in place good management.

At least that was the testimony earlier.

MR. JOHNSON: Well, as I think I mentioned earlier --

MR. ROBINSON: Because you, too, were an accountant in your former life, weren't you?

MR. JOHNSON: I beg your pardon?

MR. ROBINSON: You were an accountant in your former life, too, were you not?

(Laughter.)

MR. ROBINSON: No, but I mean it's something you have to remember. I mean, if you buy the testimony that we received earlier that you have good management, you have a viable product, Commissioner Brunner is dealing in very adverse situation. He has management that's presumably is rotten. An I mean that's how they got themselves in this pickle. I mean I know some details of some of the Ticor stuff. And where they're marketing stuff at one third of what their actual cost is in order to get a piece of the market.

They got a piece of the market and pffft. That's just one of their subsidiaries. But the home mortgage guarantee business. But that's not, I mean, that's not analogous to this situation that's currently before the Committee. Other than the fact that they're both governmental entities. So, if he is doing so well with the bidding process, and this is my final question.

If he is doing so well with the bidding process with distressed companies -- and I use that word, you know, to be very kind to them -- then it would imply that we could achieve tremendous benefits for the beneficiaries of charitable trusts if we used a similar type of situation with very viable working companies.

UNIDENTIFED: (Unintelligible) Texaco declaring bankruptcy as a result of a bidding war that went on a year or two ago. So, bidding --

MR. ROBINSON: I think there might be, depending upon your interpretation of that, some responsibility on management for involving themselves in trying to protect their own bacon.

CHAIRMAN McALISTER: Incidently --

MR. JOHNSON: And I would argue, Mr. Robinson, that is inherent in any bidding process.

MR. ROBINSON: I'm not saying it isn't, Mr. Johnson.

CHAIRMAN McALISTER: Incidently, Stern still has several hundred thousand shares of Texaco stock.

(Laughter.)

CHAIRMAN McALISTER: Still.

UNIDENTIFIED: Oops.

MR. ROBINSON: I wish I'd studied that quite well.

CHAIRMAN McALISTER: Well, not really. Not what they've still go.

MR. ROBINSON: (Unintelligible). I understand. We don't need to open up that Pandora's box. We've got enough problems.

UNIDENTIFIED: Another example.

UNIDENTIFIED: Yeah. We have two problems on our hands.

CHAIRMAN McALISTER: All right. Thank you, Mr. Bunner. We appriciate your helping. All right, I guess we will be able to bring ourselves at least soon up to pace in our schedule here. We'll call on Commissioner Tom again. And after Commissioner Tom is through we will take our lunch and recess. Commissioner will give us some background on the two case studies that will prepare us for the bulk of our work this afternoon, then.

MR. TOM: Thank you, Mr. Chairman. This portion of our presentation will focus first on FHP's conversion, which took place very recently, and the second part, if you'd like us to go directly into, will be fine, is on Foundation Health Plan, which was later added to the agenda of case studies to be addressed in these interim hearings.

First, FHP. The Department's original order approving the conversion of FHP was dated September 20 of 1985 and expired on October 7, 1985. As others have testified, as a result of the intervening litigation, FHP was unable to convert within the time limits set forth in the first order, so that following the conclusion of at least the phase of the litigation, a further application was filed by FHP, resulting on November 25, in the

Department's second order approving the conversion of FHP to for-profit status.

I'll try to summarize briefly the chronology of the key events, and the substantive considerations that went on during the period of time that we were assessing that conversion.

As is the case with most conversions, the difficult task in the conversion of FHP was the determination of the fair market value of the plan. The department used standard business valuation techniques, which have been addressed by other speakers, as it had in the past HCSP conversions.

The Department determined that neither the original valuation analysis that was submitted by FHP in its first application -- and this goes back to like February of this year, and indicated a value of about thirteen and a half million dollars, nor the second valuation analysis submitted by FHP, which indicated a value of some twenty-one and a half million dollars, fully reflected FHP's current value at the time of conversion, and therefore, the Department required that a third valuation be undertaken.

By mutual agreement, Ernst & Whinney, which is one of the large accounting firms, as is Peete, Marwick, Mitchell & Co., was selected to undertake this valuation.

The Ernst & Whinney valuation looked at three of the accepted methods of business valuation, adjusted book value, capitalized historical earnings, and discounted future cash flow.

They also considered the economic benefit which FHP had received while operating as a non-profit corporation. In summary, the adjusted book value method yielded the highest valuation amount of the three, and was selected by Ernst & Whinney as the most representative of the three methods in FHP's valuation.

As a result of the use of that valuation, plus additional adjustments largely based upon the earnings of FHP from the date of that valuation to the date of conversion -- excuse me. To the date of the first order of conversion by the Department -- a charitable settlement of $36 million was agreed to.

Prior to having approved the settmement amount --

MR. ROBINSON: Excuse me. Mr. Chairman --

CHAIRMAN McALISTER: Could we let him finish, at least this portion of --

MR. ROBINSON: It's a detail question.

CHAIRMAN McALISTER: What?

MR. ROBINSON: It's a detailed questions -- whatever the pleasure of the Chair is.

CHAIRMAN McALISTER: I would really appreciate if we'd wait, because I want to give him a chance to just lay it all out. Okay.

MR. TOM: Prior to having approved the $36 million settlement, the Department had received a letter, or a copy of a letter that was dated September 6th, which was some two, three weeks, maybe, before our order of approval, from Maxicare, another for-profit HMO, which apparently assumed that FHP had been or would soon sell under circumstances which would permit them to bid, and they offered $30 million.

On September 11th, Maxicare filed its motion with the Superior Court, as Ms. Ordin had mentioned, asking for a peremptory writ of mandate, which would have required that the Department disapprove the proposed conversion at $36 million -- not at 36 million -- involving the management of the company, and accept Maxicare's offer or an equal or more advantageous offer.

Subsequently, Maxicare's motion was taken off calendar, and the related, I guess is a fair way to characterize it, the related action of the Attorney General for a temporary restraining order to prevent FHP from converting, and preventing us from committing to conversion, took place.

And on October 3rd, the judge of the Los Angeles Superior Court granted a 15-day period, to October 18th, when there was a further hearing on the motion.

Now, remember that by October 18th, our previous order that expired on October 7th, permitting the conversion, would have expired. And did expire. The Department's position that standard business valuation techniques used in past health care conversions were appropriate means for determining the charitable settlement in this conversion were, I believe, confirmed by the court in the October 18th hearing, when its opinion included the following statement, and I quote, "The HMO conversion scheme established by the Legislature doesn't require that an HMO sell to the highest bidder who is likely to be a competitor, but does specifically envision that the people that created the entity are likely to be, and encouraged to be those who continue to control the operation after it turns into a for-profit corporation.

"And the legal test, in this court's view, is not whether it was the highest lawful bid, but whether there was a fair value. Those are different questions."

And the court goes on to say,

"It may well have much higher value to a competitor than the fair market value, to somebody who simply would be investing in this enterprise, and not in any competitor by so doing."

End of quote.

And I think that the testimony the Committee just heard from Ms. Tanner would be consistent with the court's determination in that regard.

Therefore, a competitor's bid isn't necessarily the true measure of fair market value, according to that language in the opinion, and that was our view, and continues to be our view as well.

Now, in order to determine the charitable settlement, following that court decision, FHP was required to file a second motion of material modification, which included, among other things, update of the material information in the first application.

That would include, for example, more current financial statements of FHP, showing its operations, I think it was through September 30, 1985, and an update of the Ernst & Whinney appraisal. And we have among the papers that were filed with us and reviewed by us, a followup written report by Ernst & Whinney, with respect to that appraisal.

The Department took several steps in this regard. First, the Department considered the opinion of bond counsel selected by the State Treasurer, because an issue had arisen as to whether or not, and to what extent, the redemption of FHP bonds was required before the conversion took place, in order to preserve the tax status of those bonds.

And we were provided by the State Treasurer's office with a copy of the legal opinion that had been received by them, or by FHP with a copy to them, of the firm of Brown, Wood, Ivy, Mitchell & Petty, which were engaged as bond counsel for that opinion, which held that the interest on the California Health Facility authority's revenue bond, which had been borrowed by FHP, would continue to be tax exempt, in the event that there was a conversion, even if it occurred prior to the completion of the redemption process that had already begun by that time.

We did not receive any contrary opinion from the office of the State Treasurer, and we therefore relied upon the opinion of that bond counsel in permitting the conversion to take place at the time that it did.

The Department again considered whether there were any past related party transactions, the subject that was a part of the litigation, which necessitated an adjustment of the settlement amount. And based upon our review of previously requested material, and also upon the opinion of Ernst & Whinney, the Department determined that there was no need to adjust the charitable settlement amount because of past related party transactions.

Third, the Department determined that 98 percent of the net book value of FHP's real estate, real property, should be supported by appraisals or have been acquired within three months of the valuation date, so that the transaction price established by it would be reasonably representative of fair market value at that time, or at the time of valuation that would otherwise take place.

And as a result of a review of these appraisals, the values of real estate utilized in the adjusted book value method evaluation used by Ernst & Whinney, was increased by over $3 million.

The Department further obtained from Ernst & Whinney, an update of the valuatoin to September 30th, which were more recent financial statements than were available at the time of its original valuation.

This updating took account of the results of operation through September 30, and operating on a profitable basis, obviously the additional profits earned by FHP during the period that should be reflected.

This updated valuation analysis showed a fair market value of FHP as of September 30, 1985, of approximately $36 million.

The Department also considered whether Maxicare's letter dated September 26, 1985, offering to purchase FHP's assets for $50 million, and the prospect of possibly other offers from Maxicare or even other people, or companies, I should say, required any adjustment to fair market value. The Department determined that such offers and prospective offers are not appropriate or reliable determinants of the charitable settlement in this proceeding, and accordingly no adjustment was made or indicated in our view.

The Department considered a memo that was prepared by Ernst & Whinney dated October 31, 1985, which expressed the opinion that the value of FHP by reference to market price of publicly held HMO's, which was one of the valuation methods that was proffered by some as an appropriate valuation method, or by reference to prices paid in acquisitions of HMO's, would be inappropriate in determining the fair value of FHP for conversions purposes, and we can discuss the reasons for that in a moment.

Subsequent to September 30th, FHP continued to earn net profits at the rate of approximately $40,000 per day. And therefore, to compensate for these profits earned subsequent to the September 30th valuation date of Ernst & Whinney, up to the November 27th date, when our order permitted the conversion to take place, we adjusted by $2,320,000, the amount that Ernst & Whinney had determined to be the fair market value, by adding that amount to it.

So in the end, the amount of the charitable settlement stood at $38,457,000.

I'd now, Mr. Chairman, like to talk about the payout terms, becauase that was also one of the points in issue, what were the terms under which FHP was and is required to pay out the thirty-eight and a half million dollar settlement.

In the past, both under the Attorney General's supervision and our own, payout terms have varied from usually between 10 and 20 percent of the amount of the settlement, in terms of the amount of initial cash paid, with the balance deferred over a period of time. And we took into consideration those kinds of guidelines.

Obviously, as some of the members of the Committee have expressed, it was our interest in not only determining the fair market value, but at the same time, preserving the financial viability of the health organization after the conversion, so that we would know that it would have enough cash and other resources to continue to operate afterwards, as a successful operation for the benefit of its enrolees.

The payout terms in the FHP conversion required that $7,200,000 in cash be contributed to a foundation -- excuse me -- the FHP foundation, which was created, and which today is subject to the supervision of the Attorney General under its charitable trust jurisdiction.

FHP would execute a promissory note to the foundation for the balance of $28,800,000. And that note, that balance, would bear interest at the rate of ten percent per annum, payable in annual payments commencing on October 1, 1986.

The unpaid principal balance of the note, and the accrued and unpaid interest, would be due and payable in full, that is, the last increment would be paid, on October 1, 1995. Then there was a second note entered into, of $2,457,000. This note also bears interest at ten percent per annum, and it is payable within two years.

It is that note that is convertible, in the event of a public offering, of the new entity that now owns FHP, it's called HMO Health Group, Inc., if that entity has a public offering of any of its common stock within two years from the conversion date.

And the number of shares into which that two and a half million note will be convertible is equal to ten percent of the shares outstanding at the date of conversion. The Department has also required that FHP convey to the foundation a security interest as collateral, in other words, on these notes, in all of FHP's commercial accounts, trade receivables, now owned or hereafter acquired by FHP, for health care services provided to FHP's members.

Further, as additional security, FHP is required to pledge $3,786,000 to be deposited in the account of a California financial institution.

I mentioned before that the charity that was created in order to receive these assets in the conversion, was FHP foundation. And I would like to quote from its bylaws as to what its charitable purpose would be, because that is the objective of the foundation which would guide its board of directors as well as, I presume, the Attorney General in its oversight of the charitable trust. It goes as follows:

> "To support, to sponsor and to promote charitable community activities and educational research, development and other activities in all areas related to health care delivery."

End of quote.

Upon conversion, 100 percent of FHP's stock, not it's in a for-profit status, 100 percent of the stock is issued to HMO health group, in other words, they created a wholly-owned holding company, and that holding company has made the following undertakings. That it would not make a public offering of its stock for six months after the date of conversion, and it has also agreed, along with its management, to limitations on the transfer of shares by its current shareholders for a period of two years. So, in summary, the department concluded in this conversion on the following grounds: first, that a proper valuation meth...that proper valuation methods were used to determine a fair and reasonable charitable settlement amount. Second, the payout terms were reasonable in light of historic practice by ourselves and the attorney general and with a view to preserving the financial and fiscal integrity of the surviving organization. Third, that the present value of the consideration

MR. TOM: -- of the surviving organization. Third, that the present value of the consideration to be given by FHP in the charitable settlement is not less than $38 million, since interest and collateral was provided for.

Fourth, that the security agreement insures that the payout terms will be met. Fifth, that the settlement amount will be donated to and used for an appropriate purpose by a charity of like purpose to FHP itself when it operated as a non-profit institution, which will be substantially unrelated to FHP, as a result of limitations on the number of directors with affiliated transactions and as a result of undertaking that there be no transactions entered into for the direct or indirect benefit of FHP by this charity.

Sixth, that approval of the purchase of the capital stock of FHP by the HMO health group is appropriate under the conditions indicated, and finally, that the proposed purchase of stock may reasonably be expected to promote the delivery of health and medical care to the people of the State of California.

That, Mr. Chairman, concludes our presentation on the background regarding the conversion of FHP. I'd be glad to entertain Mr. Robinson's questions, or any other member's questions.

CHAIRMAN McALISTER: There are just one or two questions I have first. How long, uh, will it take for the $28,800,000 promissory note to be paid?

MR. TOM: Over a ten-year period.

CHAIRMAN McALISTER: That's ten years. And this other --

MR. TOM: Yes, it's in installments over a ten-year period.

CHAIRMAN McALISTER: And the other, the two and a half million dollar note is two years?

MR. TOM: Two years in duration, yes.

CHAIRMAN McALISTER: All right. Now, how can you say that they're getting the present value of thirty-eight and a half million dollars, when they're taking promissory notes that are going to take ten years to be paid?

MR. TOM: Because they're paying interest. The mortgage on your house, if you have a mortgage on your house, is not worth less than its face value because you pay interest on it.

CHAIRMAN McALISTER: And you mean if somebody wants to buy from a savings and loan the mortgage on my house, they are going to pay the face value on that loan?

MR. TOM: Well, I don't know.

CHAIRMAN McALISTER: You don't know?

MR. TOM: No.

CHAIRMAN McALISTER: Well, now, really. I mean, how -- Mr. Robinson? How many people will pay the face value on a ten-year note if they want to buy it right now?

MR. TOM: It depends.

CHAIRMAN McALISTER: Okay --

MR. ROBINSON: Well, it would depend considerably on what the interest rate is. It would be more than face -- at 10 percent interest, and I mean, I don't know what the prevailing rate was on a light security at that time.

CHAIRMAN McALISTER: What's the interest rate on this note?

MR. TOM: Ten percent, sir.

CHAIRMAN McALISTER: Ten percent?

MR. TOM: Yes.

CHAIRMAN McALISTER: And you believe that there are --

MR. ROBINSON: Was that established because of the usury statute? Is that -- where did that ten percent come from --

CHAIRMAN McALISTER: Well, I don't know. It just says the note will bear -- anyway, he says it'll bear interest at ten percent.

MR. TOM: Mr. Chairman, the reason I made that statement was -- anticipating or responding to the criticism that we had gotten from other sources outside of this -- of these hearings, that a $30 million note payable over a ten-year period, you know, is only worth $15 million, because you don't get the money until, you know, a period of time up to ten years away. Obviously when you discount it to the present value, it's worth a lot less.

MR. ROBINSON: Yeah, but depending upon the --

MR. TOM: And perhaps you -- which all of which is true, except that you then have to add back in the value of that interest in order to get a true fair market.

MR. ROBINSON: You have to add in the value of the security for the note, in order to determine the interest rate. Because the interest rate is going to be determined by the level of risk. Ten percent sounds low -- I mean, there's many municipalities that are going out, going to market now on tax exempts at eight percent.

Anyway, there are all kinds of variables, you know, whether or not, you know, the note is callable earlier, all kinds of other variables which would impact on the interest rate. I mean, I'd like to know how they determine that. I'd -- and there's a whole lot -- I'd like to see a lot of this Ernst-Whitney information. Yeah, that's right.

I mean, the whole structure of that note is very very important as to whether or not the, you know, interest rate is reasonable, et cetera.

CHAIRMAN McALISTER: There's something else. You mentioned that fair value is all that's required. Now where did this term fair value come from? I've never heard of such a term. I thought it was fair market value.

MR. TOM: I didn't mean that there would be a difference. Both of those terms, I have, at least personally, used interchangeably as did the court opinion use interchangeably.

CHAIRMAN McALISTER: All right. Now, are your additional witnesses here going to explain to us why reference to market prices of publicly held HMO's, et cetera, would not be appropriate?

MR. TOM: I'd be glad to do that with the assistance of my colleagues if you'd like me to do that at this time.

CHAIRMAN McALISTER: Okay.

MR. TOM: Dave, would you turn to that chart so the Committee can see it? Maybe bring it out a little bit?

It may help to be able to illustrate, at this point, if you will recall back to Ms. Tanner's testimony on the use of market values of comparable companies, she pointed out that one of the determinants of whether you can even utilize this method, in addition to whether you ought to utilize the method, is, are there comparable companies out there that you can take a look at?

Well, it's easy to say, I think, that of course, there are, in fact, other HMO's whose shares are publicly traded, and that, by opening any newspaper, we can take a look at what those prices are, and what the price-earnings ratios are, and so forth.

But are they, in fact, comparable, other than the fact that they are all in the HMO business? The fact is that they are not. There is not one, not a single publicly owned HMO that is what we call a staff model HMO, which is what FHP is.

A staff model HMO is an integrated operation. It owns its facilities, it owns its hospitals, it employs its doctors and other medical and other professionals, it is an integrated operation and obviously involves a far higher degree of capital intensity to make its -- to perform its operations, excuse me, as well as to grow.

All of the HMO's whose shares are publicly traded are what we call IPA models, or network models. That is, the relationships are based on contracts. The HMO goes into a market place, identifies the market place it wants to go into, signs up contracts with hospitals, doctors, and so forth, in order to provide the services to the enrollees it hopes to get, attracts those enrollees, and provides those services through that contractual mechanism.

You don't need to build hospitals. You don't need to provide payroll for expensive medical professionals.

And so, there is a very significant difference between staff model HMO's and IPA model HMO's. Now, the market of public securities is entirely IPA, and at the very end of that, network type HMO's. And as a matter of fact, you can see from this chart what that difference means. We have selected several California based HMO's for illustration.

The first, moving from the left, shows the growth rate of FHP, the case study in question. And and these, by the way, these are the data we were able to get -- we did not select the others because the charts are higher, but you can see a dramatic difference in the annual growth rates of these organizations simply because IPA model HMO's can grow much faster.

It's a matter of getting enough contracted providers, but not to discount the influence of management when you have a situation like that, of course.

MR. SEASTRAND: But Mr. Tom, how long a period, how many years is this growth rate based on?

MR. TOM: Over what length of time, is it a five-year period? I'm sorry, this is the most recent annual data that was published in an HMO publication, so I think it only reflects their most recent fiscal year, it does not reflect an historical five-year average.

MR. SEASTRAND: Yeah, well, that's a very poor illustration in my mind -- one year doesn't reflect anything.

If you want to go to from five to ten year growth rates, well then you might be looking at something, but one year doesn't indicate anything.

MR. TOM: Mr. Seastrand, you're correct. And we should have done that; unfortunately, time didn't permit us to.

If you'd like, we'd be glad to supply that supplementally, but in my judgment, it would not change dramatically the differences that you see here. FHP's growth rate has historically stayed at the level that you see in this chart. The growth rates of the other plans in the last several years has stayed pretty much the same as you see in these plans, in these charts.

CHAIRMAN McALISTER: All right. Any other questions of the Commissioner on this point? Or on these points? Oh, all right, why don't you go back, now, this is a good time to correct --

MR. ROBINSON: What I'd like to do is get copies for after lunch. I'd like a copy of the note.

MR. TOM: I'm sorry, I just --

MR. ROBINSON: You don't have that -- you don't have a copy of the note, the one the Chairman was discussing earlier, the ten percent interest? Was it -- yeah, I want a copy of it so I can, we can analyze the terms of it.

Then, I'd like copies of the bond council opinion on the -- Mr. Seastrand and I serve on a committee that has jurisdiction over all these tax-exempt bonds, and we are very concerned. I'd like to know more details on that tax-exempt bond, too. I'd like to know -- I assume it's a health facilities bond.

I'd like to know the amount, and the interest rate, and the underwriter, and the bond -- I mean, the original bond council on the -- issuance of the note.

MR. TOM: We'd be glad to provide it to you.

MR. ROBINSON: And we'd like copies of the Ernst-Whitney opinion and all correspondence with the department from Ernst-Whitney, so we can look at that. It'll help alleviate a lot of technical questions, and I'll try to develop the technical questions from that. If we could have that by the end of the lunch hour.

CHAIRMAN McALISTER: Okay, please furnish our staff counsel with this material too.

MR. TOM: All right, do I understand that you would like that in the afternoon session? I think that all of the things that you have mentioned we have --

MR. ROBINSON: I understand there's been some problem in the department with Xerox capacity, but it's not that far from us, you could --

MR. TOM: No, I just said, I think we have all that with us.

MR. ROBINSON: Oh, okay. Okay that's fine.

MR. TOM: It's simply a matter of taking it out of, you know --

MR. ROBINSON: In that case, if it could be turned over to the Committee and the Committee could supply it to any other members.

CHAIRMAN McALISTER: They can make copies of it if they'll do that.

MR. ROBINSON: I know Mr. Seastrand is my vice-chairman, and we're going to be very concerned about the health facilities thing. But I'd also want to look at all the Ernst and Whitney thing, as well as the note.

MR. TOM: Fine, be glad to do that.

CHAIRMAN McALISTER: All right. Well, then why don't you proceed?

MR. TOM: All right. Should I move on then to the Foundation Health Plan matter?

CHAIRMAN McALISTER: Yes, go ahead, do that.

MR. TOM: Case studies, excuse me. Okay, now this is on Foundation Health Plan, and Dave, maybe you can turn to the --

CHAIRMAN McALISTER: This is the Sacramento-based organization, right?

MR. TOM: That's correct, it is. The department's order approving the conversion of Foundation Health Plan was dated in February of 1984.

And I'll briefly summarize the major substantive events that took place in connection with that conversion. In this case, the charitable contribution was accomplished by the issuance of 100 percent of the Foundation stock to a newly created charity, which in effect transferred 100 percent of the newly converted entity's value, I mean by definition, it would have done that.

Therefore, the valuation was represented by the stock, not by any determination as we had in the FHP situation, of trying to determine what the cash equivalent price would be.

However, we did undertake a valuation for purposes of determining a minimum guaranteed value of the stock, because obviously the stock can have a fluctuating value, including a downward fluctuating value, and we're concerned that because this conversion was taking place on a virtually purely equity basis, that the stock price might not be realized and the charity might not realize the considerable value that Foundation Health Plan had achieved at the time of conversion.

So, we again required the the company, Foundation, to engage in a valuation and to -- in that case they engaged Price Waterhouse and Company to assist in the valuation. The valuation that was used was a composite valuation. That is, they didn't pick just one method, but a series of methods, a number of methods, which we've talked about today already, and then placed, weighted each one of those methods, and it went something like this.

The methods used were book value, historical book value, adjusted book value, capitalized earnings, market value, and goodwill value.

The book value, first, the plan had a consolidated net worth at June 30, 1983, it's last fiscal year at that time, of $5,753,000. And this amount reflected the net worth based upon historical costs and generally accepted accounting principles type of accounting it its financial statements.

The second was adjusted book value. Using this method, the assets and the liabilities were adjusted to their -- from their book value to market value. And the principal adjustments were the following. The land and buildings were increased by approximately $634,000. And then the plan also felt that, in determining market value, the depreciable fixed assets, furniture and equipment, should be subject to a discount, and that discount was arrived at at 30 percent and that resulted in a $29,000 adjustment, not a particularly material amount. This amount, when combined with the positive amount of $634,000, increased the value of all of their tangible assets by $605,000.

And so that was added to the net historical book value, thus resulting in adjusted book value of $6,358,000. The capitalized earnings method was used in estimating earnings potential. The plan considered the net income for the year ending June 30, 1983, due to the fact that operating losses had occurred in all of the prior startup years. In other words, that year was its first year, first full fiscal year of profitable operations, and as has been expressed by some of the other expert testimony this morning, normally one uses a period of time, but in this case, there's only one profitable year if we had used, say, a five or three year average, it obviously would have significantly reduced the average annual earnings. So we just --

MR. ROBINSON: Were there any extraordinary losses in those previous three years?

MR. TOM: I beg your pardon?

MR. ROBINSON: Were there any extraordinary losses in those previous three years --

MR. TOM: I'm not sure. The losses were reasonably modest and were based primarily on the startup nature of the company, because it had only been in operation for some four or five years, I think.

MR. ROBINSON: They were not considered one-time losses of an extraordinary nature. They were --

MR. TOM: No, I don't, I don't believe so, Mr. Robinson. I've been advised that my assumption was correct. Or extraordinary gains.

UNIDENTIFIED: There were extraordinary gains.

MR. TOM: Oh. We did adjust the June 30 profit number, however, because there had been a writeoff of an accumulated provider withhold in December of 1982, which was a non-recurring item that should have been -- should have been spread out, and therefore, this reduced health care costs by about two and a half million dollars, resulting in a corresponding increase in net income.

So we, we backed that number in -- that is we put that number back in as if it had been an expense that year. The resulting income of $4,320,000 was further reduced by $2,203,000, which represented the estimated federal and state tax payable by the entity in its -- had it been in a pro forma for-profit status. Thus we had a representative net income of $2,117,000 as adjusted in the manner in which I have indicated.

In this case we've used a 20 percent capitalization rate, which means we multiplied that by five to determine what the capitalized earnings would amount to, and that came to $10,585,000.

In the market value test, the plan reviewed five publicly traded companies, which it indicated had operating HMO's and determined that on the average the market value of their shares was approximately 339 percent of book value.

We applied this percentage, or they applied this percentage to the Foundation's tax-expected valuation, and that yielded a market value of $16,865,000. What we call goodwill value.

To determine goodwill, the plan capitalized its earnings during the year ended December 30 -- I'm sorry, June 30, 1983, the year in which it had had profits, which were in excess of a reasonable rate of return on its net tangible assets at June 30, 1983, and added that amount to the net book value of tangible assets at that date. For this purpose, what was used was an eighteen and two-thirds percent figure as a fair rate of return on tangible assets in this kind of organization.

And the earnings attributable to goodwill, that is, the earnings achieved in excess of that 18 percent return, was $1,043,000. We then used, again, the 20 percent capitalization rate that had been used in the previous test on that million dollars of excess earnings, and came up with a good will value of

$5,215,000.

You then take that goodwill value, and add it to net book value of five million seven, and that results in a valuation of approximately $11 million. The chart that is showing there on the board now summarizes the various methodologies that I've mentioned, and you will see that next to each of the values is a percentage.

The total of all of those percentages, hopefully is 100 percent. This is a weighting of each of the factors that was used in the valuation. And as you can see in this case, a very small amount of the total value was based upon historical and adjusted book value. Five percent each. The largest component by far was capitalized earnings, and then 25 percent each based upon market value and goodwill, or really what it should be is goodwill plus book value. That resulted in an $11,798,000 value on that weighted basis for Foundation Health Plan. From that was discounted ten percent for non-marketability, which is a discount that is generally recognized for IRS purposes for non-marketable shares, which this would be.

MR. JOHNSON: Mr. Tom.

MR. TOM: Yes.

MR. JOHNSON: Mr. Tom, could you tell me the date of this valuation? The date of the conversion, and the settlement price?

MR. TOM: The date of the conversion was February, 1985 and --

CHAIRMAN McALISTER: '84 --

MR. TOM: '84, excuse me, and the valuation would have been sometime shortly prior to that date. So here you can see it was a more elaborate five method type and then followed by a weighting.

I'd like to emphasize at this point that this entire exercise was in order to determine a minimum guaranteed value for the shares of the Foundation Health Plan, which were contributed to the new charitable entity, which is called Sierra Foundation for Health.

MR. CONNELLY: Mr. Tom, if 100 percent, or all of the stock went to this charitable trust, what difference does it make what value it is?

MR. TOM: Well, as a matter of fact, that is an argument that was, and could very rationally be made by the management of the company that they've already given all of the stock --

MR. CONNELLY: Did any --

MR. TOM: Our concern was that --

MR. CONNELLY: Did any stock --

MR. TOM: -- maybe we shouldn't be accepting all stock. Maybe we should guarantee that the stock is going to achieve a value in the future.

MR. CONNELLY: Did any stock go to the management?

MR. TOM: (Unintelligible) that you had earlier.

MR. CONNELLY: Did any stock go to the management?

MR. TOM: Yes it did, subsequently.

MR. CONNELLY: So 100 percent of the stock didn't end up in a charitable trust.

MR. TOM: No, it did not. Absolutely did not.

MR. CONNELLY: So, the discussion as to whether or not the stock represented the full value is a very reasonable factor for you to evaluate, and I assume that's why you went through this analysis, right?

How much of the stock did end up in private hands? Not after the public sale, but as a function of the conversion process?

MR. TOM: It was about two -- I think it was around two million shares involved in the combination of a number of sales that were, that were sales preceding a public offering, and then there was a public offering of the stock presented to the public.

MR. CONNELLY: Okay, preceding the public offering, were any of those sales to people who were previously management employees, or on the board of directors of the Foundation?

MR. TOM: Yes.

MR. CONNELLY: And how much did they purchase? Either in terms --

MR. TOM: Approximately, well --

MR. ROBINSON: How about percentages --

MR. CONNELLY: How about percentages?

MR. TOM: Can you hold on for just a moment? Let me calculate those percentages roughly.

CHAIRMAN McALISTER: It's in the range of 20 percent to 30 percent --

MR. CONNELLY: It's about 20 percent to 30 percent, isn't it, I don't --

MR. TOM: Yeah, I know, but the question is --

CHAIRMAN McALISTER: It was initially contemplated --

MR. TOM: Maybe we could work together on this and it'll save a little time.

MR. ROBINSON: Well, tell us --

CHAIRMAN McALISTER: To find the percentage that was initially contemplated would be 30 percent.

MR. TOM: I beg your pardon.

CHAIRMAN McALISTER: The initial contemplation was 30 percent. That was the initial deal.

MR. TOM: Right, right.

MR. CONNELLY: So, they, they had it as --

MR. TOM: Let me give the numbers, because that may be important when we get to other questions, and I think Mr. Robinson specifically asked for them.

MR. CONNELLY: Sure.

MR. TOM: Sierra, the foundation, you might turn to that chart with the -- Sierra received 2,536,000 shares.

MR. CONNELLY: Um-hmm.

MR. TOM: And at that time, that was 100 percent, but clearly that was not -- it was contemplated all along that there would be additional shares issued.

MR. CONNELLY: I see, so that's the charitable trust.

MR. TOM: That.

MR. CONNELLY: And then --

MR. TOM: So that establishes ownership by the foundation.

MR. CONNELLY: Right.

MR. TOM: Then -- and this occurred about six months following the conversion.

MR. CONNELLY: I understand.

MR. TOM: So the first six months, the charity owned 100 percent of the stock. Why can I not find the million shares? There was a --

MR. CONNELLY: Those are quite exact numbers, it seems to me they ought to have some sense --

MR. TOM: There there was a stock purchase plan and stock options issued in September of 1984, five, six months after the conversion, covering 1,006,000 shares of common stock at $7.65 per share. See, for stock option purposes, as many of you know --

MR. CONNELLY: At the time --

MR. TOM: -- is to set an option price, that is, a price at which the options are exercised --

MR. CONNELLY: At the time the department --

MR. TOM: One hundred percent of its fair market value at that time.

MR. CONNELLY: At the time the department approved the conversion, you knew that there would be stock options that would be exercised by private parties.

MR. TOM: We knew that there would be stock options issued, and stock purchase plans to management, and to providers, doctors, and --

MR. CONNELLY: Right.

MR. TOM: Other people. Amounting to about 1,200,000 shares.

MR. CONNELLY: Which is roughly about 30 percent of the total stock portfolio.

MR. TOM: All right.

MR. CONNELLY: Was there a guaranteed price for those stocks?

MR. TOM: Those shares were to be issued at fair market value, and that's why when those shares that I just mentioned to you, the 1,006,000 shares were issued under options at $7.65 a share.

MR. CONNELLY: And that price, the initial option price on the stock, was a formula, I guess, to consider what the fair market value of the entity was at the date of transfer.

MR. TOM: Before each stock issuance, including this 1,006,000 and some others that I'll mention to you, prior to the public offering, Foundation secured from independent sources, fair market value appraisals similar to, but not the same as the one that they submitted to us and that we relied on in connection with the conversion.

MR. CONNELLY: Okay, so they, the private entities had stock options as part of the conversion. Did they exercise the stock option?

MR. TOM: Some did. The data are these. As of June 30 of this year, 302,000 shares have been exercised. 322,000 shares have expired or been forfeited, and the balance either have not been issued, or are held by people who have not yet exercised them.

MR. CONNELLY: I see. And of those that did exercise them, what experience did they have? I mean, they effected a purchase of how much, and where is that stock now? If they spend $10 in exercising the option subsequent to the date of conversion, what would that $10 be worth today?

MR. TOM: Well, the price that they bought the stock for would have been the $7.65 price. There has been since that date a two and a half for one stock split, so what does that come to?

Maybe about, say roughly $3 a share. A little less than $3 a share, I guess, would be their adjusted basis for each of the post split shares. The current market value of foundation stock is approximately $9 a share.

MR. CONNELLY: So there's been roughly a 300 percent increase in eighteen months?

MR. TOM: Yes. It --

MR. ROBINSON: After 30 percent --

MR. CONNELLY: Just so I can put this in dollar terms, if I exercised by options in the 300,000 shares you refer to, how much would I have invested, I would have invested what? A million dollars, two million dollars?

MR. TOM: A million one hundred thousand approximately.

MR. CONNELLY: And I would now have $7,000,000?

MR. TOM: Yeah, whatever, that sounds right.

MR. CONNELLY: Is that their own money, or is that money that they derived --

MR. TOM: Their own money. You're required to utilize your own funds in exercising stock options. I mean, this is a general tax rule I presume that was followed in Foundation's case, I don't know that for a fact. I assume it was --

MR. CONNELLY: Right. One of the things that I don't understand, and I'm sure you have an explanation for this, because it has been brought out, is how they could file a document with the Securities and Exchange Commission in March of 198 --

MR. CONNELLY: because it has been brought out, is how they could file a document with the Securities and Exchange Commission in March of 1984 that said the corporate entity was worth $19 million and yet you approved a valuation $10 million three days before.

MR. TOM: Well, first of all, the previous chart, the value of ten million six or thereabouts I had emphasized, was for the purpose of providing a minimum guarantee.

It's very common in deals, for example, on just sale of industrial companies generally, that where it is based on stock, where the buyer, in effect, pays for it in paper rather than in cash, or in stock paper rather than cash paper, to have a minimum guarantee of value. That was our objective is to provide --

MR. CONNELLY: Well, in this instance the minimum guarantee --

MR. TOM: -- for that minimum guarantee of value. It may or may not be absolutely equal to the fair market value because after all the charity gets all the upside, which, in fact, is worth $50 million in this game. Fifty million dollars.

MR. CONNELLY: How about the private party who gets the upside. In other words, if you undervalue the stock across the board at the outset with your evaluation, and then you divide it into two clumps, one clump that goes to charity and the other clump that goes to you, if charity gets the upvalue, that's fine, they would have gotten it if it had been evaluated properly at the outset, but you get the upvalue as well. And --

MR. TOM: Very often --

MR. CONNELLY: -- isn't that bothersome?

MR. TOM: Well, the people who got this stock under these options got them at the fair market value at the time that they got their options. That price happened to have been substantially lower than the price that exists now.

To what extent, and it's a legitimate question for inquiry to look at that $7.65 value and say, was that a proper determination of fair market value at the time the options were issued?

MR. CONNELLY: Well, what I don't understand --

MR. TOM: If it isn't, then maybe somebody is subject to criticism.

MR. CONNELLY: Well, I don't understand --

MR. TOM: And the growth of value from that date until today --

MR. CONNELLY: Yeah --

MR. TOM: -- may just as likely be attributable to the efforts of the very people who received those shares as to any other --

MR. CONNELLY: Well, if the stock had been valued based upon the document filed with the Securities and Exchange Commission at the 19 million instead of the figure that you've --

MR. TOM: I'm unfamiliar with -- what that is --

MR. CONNELLY: Well, let me just give this with this to you.

CHAIRMAN McALISTER: Yes. Members of the Committee have the document. It's a copy of a registration statement form S1 under the Securities Act of 1933. And at the bottom of it, at least the bottom of page F3 it says -- this is a statement by Americare Health Corporation, it says, the fair value of FHB as of the date of conversion, based on appraisals, was $19 million.

MR. CONNELLY: So in effect, they doubled their value in about 72 hours. I mean at least based on the information they were providing as to the real value of the stock and given the fact, that all of the consideration in this instance was stock, stock was what really mattered.

I'm wording that terribly simply because that's my level of understanding, but --

MR. TOM: Your question is a good question. Assuming the accuracy of the statement that $19 million was the fair market value at the date of conversion, then that's fine. That meant that the value of the 2,500,000 shares of Foundation stock that went to the charity was worth $19 million.

MR. CONNELLY: Um-hmm.

MR. TOM: I mean, by definition, the stock, which was 100 percent of the stock at the time, if it was worth $19 million, was worth $19 million.

UNIDENTIFIED: Excuse me Mr. Tom, you beg his question because they had the option to buy one-third of it. I can give it all away if I have the option to buy it at that price. That's not real.

MR. TOM: It is no gift.

UNIDENTIFIED: But I have the option to buy it at that price, the preferred price.

MR. TOM: If you have -- if you buy stock at what is conceded to be the fair market value at the time, then I don't see what the problem is because that person would have paid fair value.

The public which bought this stock several months later for -- I think it was $10.25 a share paid real value. As a matter of fact an argument could be made the Foundation made off terrifically because its shares -- you know, it paid far less than that on a per share basis. But the dilution in terms of shares being issued has to be balanced against the adequacy of the price that was paid for those shares.

That's why I say it's a legitimate inquiry to inquire whether that price was fair or not at that time. It's not a legitimate inquiry in my judgment to say, gee, they made 300 percent on their stock in 18 months, isn't that great. And of course we all wish we had participated in it.

CHAIRMAN McALISTER: Mr. Tom, if this had been properly evaluated in the beginning they -- first of all, wouldn't it have raised your eyebrows somewhat about the amount of stock options that people were given?

Would that have made any difference to you? How much of the stock these insiders were allowed to buy?

MR. TOM: That was an element in the conversion, that they were permitted to issue, I think it was 1,200,000 shares to management and providers subject to, you know, the fair market value at the time of their issuance.

CHAIRMAN McALISTER: Well if this were -- okay --

MR. TOM: So that subject was addressed --

CHAIRMAN McALISTER: And if this were volume, if this stock is worth almost twice as much as it says up there on that chart when they exercised their options, wouldn't they have had to have paid more money than they actually paid for the stock?

MR. TOM: More money than what? You mean --

CHAIRMAN McALISTER: Than what they actually paid.

MR. TOM: More than the $7.65 that was provided for?

CHAIRMAN McALISTER: More than what they actually paid. If it were worth a billion dollars -- I mean if it had been valued a billion dollars, they wouldn't have exercised options on 30 percent of the stock for the amount that they did, would they?

MR. TOM: Yes, they would. The option is nothing more than a contract permitting an employee to purchase stock normally at a fixed value, that was the case here, $7.65, at any time within usually a five-year period of time. If the price of the shares is below $7, no fool is going to exercise the option. If the price is above $7, that's when the option becomes valuable, that's the management incentive that they get.

That's the bonus, in effect, that they get under this option in lieu of some cash-type incentive. And they get the benefit of the growth in dollar value. That is a stock-option. I'm not describing this stock option, I'm describing every stock option that I have ever heard of.

CHAIRMAN McALISTER: To pay -- to buy the same proportion of stock on stock options, if the stock is worth more, they would have to pay more money, wouldn't they?

MR. TOM: If they wanted to buy the same stock on the open market, absolutely right.

CHAIRMAN McALISTER: Okay, and so if you had valued this at $20 million, or $19 million, or whatever, instead of $10,600,000, in order to buy the same proportion of stock, they would have had to pay more money.

MR. SEASTRAND: Mr. Chairman, may I --

MR. TOM: Excuse me, Mr. Chairman, the $7.65 value under which these options were exercised translated into the two and a half million shares that went to this charity, is equal to something like 16 or 17 million dollars. We're not talking about the difference between zero and 19 million.

MR. SEASTRAND: It's more like $19 million --

MR. TOM: Yeah, I mean I was doing it in my head --

MR. SEASTRAND: You divide 25 into 19, you come up with $7 and something, so the stock was valued at that time at $7.65. They are basing that $7.65 on a $19 million figure.

MR. TOM: Yes.

MR. SEASTRAND: Obviously there is some dilution, but you've got $7 million worth of cash that's going into the corporation too for the exercise of those options. So --

CHAIRMAN McALISTER: You're trying to tell us it doesn't make any difference what you value this stock if somebody wants to buy 30 percent of the corporation.

MR. TOM: No.

MR. SEASTRAND: Based on $19 million that's in this document right here, the two and a half million shares that were outstanding at that time would have a value of $7.65. They offered stock based on that. Tell me where it's wrong, Sal.

MR. ROBINSON: They only gave the corporation -- the charity 70 percent of the stock --

MR. BIANCO: That's correct.

MR. ROBINSON: There's a 30 percent dilution --

MR. BIANCO: That's right -- you see --

MR. SEASTRAND: Wait a minute, it's not a dilution factor if you, they're paying cash, they're paying $7 million for this third of the company, a third of $19 million. So if the company had $19 million in assets, once this stock was exercised they had $26 million in assets.

MR. ROBINSON: But in reality, because the Commissioner testified -- and he can correct me, but he testified that 100 percent of the stock went to the charity, but that one of the terms of the deal was that it would be diluted by 30 percent immediately.

MR. SEASTRAND: Well, you can't say it was diluted because they didn't give the stock away, people had to pay for the stock at what the value of the corporation was at that time.

MR. BIANCO: Let me try and -- there's some key dates that we see.

One, at the date of conversion, it was proposed that 100 percent of Foundation Health Plan assets were to go to the charity, Sierra Foundation.

MR. SEASTRAND: And it did.

MR. BIANCO: 70 percent went to the charity.

MR. SEASTRAND: Where did 30 percent go?

MR. BIANCO: It went to the board of directors of Americare Corporation. In May of 1985 there was another transaction that took place whereby all the shares that Sierra Foundation held of Foundation Health Plan were exchanged for shares of Americare Corporation and they were non-voting shares. So you find --

MR. SEASTRAND: It gets confusing in here though, because you said that two and a half million shares was the entire holding of the corporation, right?

MR. ROBINSON: (Unintelligible) at the books, they've --

MR. TOM: The truth is somewhere in between, if I can explain. Very often in these kinds of conversions, a holding company is created. When we were talking about FHP I mentioned to you that HMO Health Group, I think was the name of it, was a holding company that was created in order to maximize the corporate flexibility of the future operation.

In this case the same thing occurred. Foundation Health Plan, when it was operated as a non-profit corporation, obviously had no parent, it had no shareholders, it was a charity, and when the conversion took place 100 percent of Foundation's stock was turned over to Sierra, the charity. There was then a reorganization under which those shares of Foundation held by the charity were exchanged for the 2,500,000 shares of Americare.

As a result of that transaction, the corporate structure looks like this, Sierra Foundation owned 100 percent, or 2,500,000 shares of Americare, which owned 100 percent of Foundation Health Plan. There was no economic change that resulted. Nobody made off with anything as a result, it was just to interject Americare Health Plan as a holding company in between Sierra Foundation and Foundation Health Plan.

MR. ROBINSON: Mr. Chairman.

CHAIRMAN McALISTER: Mr. Robinson.

MR. ROBINSON: Looking at the S1, first of all, who was the accountant for the filing of the -- with the SEC of this S1?

MR. TOM: The accountant?

MR. ROBINSON: Right, was it Price Waterhouse in both cases?

MR. TOM: Price Waterhouse.

MR. ROBINSON: In both cases. Because it's important. Your testimony earlier -- because I don't want in any way to try to sandbag you -- Price Waterhouse gave you the valuation you based your judgment on --

MR. TOM: In connection with the conversion -- correct.

MR. ROBINSON: All right, what I want to know is, on the S1 filing, registration 90157, if Price Waterhouse was the accountant.

MR. TOM: Yes it was.

MR. ROBINSON: Okay, now -- all right, now with that as the case, we're on page F3, "For purposes of this pro forma presentation, the excessive fair value of FHB on the date of conversion" -- which is three days -- "over its historical net assets as of December 21, 1983", has been allocated, which is -- this is their explanation, the difference between the two figures.

To property and equipment, long-term debt, which is tax exempt debt, which is going to be a subject of Mr. Seastrand and my committee, intangible assets, the fair value of FHB as of the date of conversion based on appraisals was $19 million. Now I want to know why Price Waterhouse can talk out of both sides of their mouth, and why you didn't ask the question, and why --

CHAIRMAN McALISTER: As a matter of fact, we have a document that indicates that the original valuation wasn't theirs either.

MR. ROBINSON: I beg your pardon?

CHAIRMAN McALISTER: The original valuation was not Price Waterhouse's.

MR. ROBINSON: Yeah, that's what I was -- it would be very -- they are a very prominent big eight accounting firm, it would suprise me seriously if they were in that conflict position.

CHAIRMAN McALISTER: The document there indicates that the Foundation people used their own value. I don't know where they got it, but they say that they substituted it for the Price Waterhouse.

MR. SEASTRAND: Well, I'd like to come back, I'm still dangling out here. You show 100 percent of the stock, whether it's Americare or whether its Sierra Foundation, and somebody over here is trying to tell me that 30 percent of the stock didn't go to them.

MR. TOM: This is as of the date that the reorganization took place and the date that the conversion took place, which was within an extremely short period of time.

MR. SEASTRAND: Okay, now is the 30 percent that we're talking about the 30 percent that went to the insiders, that's the addition, we go from two and a half million shares of whatever, we add a million six --

MR. TOM: More like three and a half million.

MR. SEASTRAND: -- so we add another million six for it.

MR. TOM: Yes, that's correct.

MR. SEASTRAND: Okay, that million six was optioned at $7.65 a share, which was based on a $19 million value or whatever it is, that's not giving away anything.

MR. JOHNSON: Did I understand you to say that 30 percent was throughout the application for the conversion was contemplated -- that this was something that came up six months later --

MR. TOM: Yes, the assumption was --

MR. JOHNSON: -- or contemplated from the beginning.

MR. TOM: The assumption was the following, that approximately a million, two hundred thousand shares would, in the future, you know, following the conversion, be issued to management personnel, providers, and similar organizations, that there would be a public offering sometime down the line, and that occurred about eighteen months after conversion as a matter of fact, during which both the Foundation, and the plan, or Americare, would participate, you know, in a combined public offering. And so those things were contemplated.

MR. SEASTRAND: The foundation participated in a public offering of stock --

MR. TOM: Yes.

MR. SEASTRAND: All right, but the Foundation had no connection with the operation of -- that is the newly created, what is it, Sierra?

MR. TOM: The charity? Yes, Sierra --

MR. SEASTRAND: Sierra had no role in the operation of Foundation Health Plan.

MR. TOM: Well, until the public offering, Foundation, I'm sorry. Until the public offering, Sierra, the charity, was either 100 percent or maybe 65 percent or something like that percent, owner of Americare, and as such was capable of and did exercise the control which you would expect a wholly owned or majority ownership shareholder to exercise.

All of the stock issuances, in option form or otherwise that took place prior to the public offering, were all done with the consent and approval of the foundation, a majority of whose directors were appointed by independent sources -- from independent sources. And so they did have that role.

Now, Mr. Bianco mentioned that the shares are non-voting. They became non-voting when the public offering took place. Prior to that time, they were voting securities. And they had to become non-voting, as I understand it, because of tax reasons involving Foundation ownership of public shares.

MR. JOHNSON: It's a little difficult to follow this because of the terminology and switching back and forth from Foundation and --

MR. TOM: Maybe we should change their names to start off with and then --

MR. JOHNSON: -- Sierra, which is a foundation, but not the Foundation, but I think I've followed you, and frankly, I'm inclined to agree with Mr. Seastrand's analysis. It was contemplated from the beginning.

MR. CONNELLY: Mr. Tom, are there any, were there any stocks transferred to the private parties that were not transferred as a part of the stock option, that is, they were given as a result of management consideration, or bonuses, or anything like that?

MR. TOM: I mentioned that there was a contemplation of approximately a million two hundred thousand shares, and so far I've only gotten to the part of the story involving the million six thousand.

There were two other issuances that took place. And I think both of these were in September of 1984. One hundred fifty thousand shares were issued under a stock purchase plan to key officers, employees, physician providers, and consultants. This was September of 1985. The purchase price involved was $11 a share, and that was based upon the determination of fair market value at that time. Also --

MR. CONNELLY: That was the same price that would have been afforded the public if they wanted to effect a purchase at that time.

MR. TOM: Presumably so. Though the public offering did not occur then. It occurred several months after, and indeed at a lower -- I'm sorry, some months after.

MR. CONNELLY: Yes, that was before the split, though. I see.

MR. TOM: Yes, I always fall into the trap of not adjusting for the split. At the same time, 55,000 shares were issued to officers as compensation for services rendered. Those 55,000 shares, based upon the $11 value used for the stock purchase plan, would have been equal in value to some half million dollars.

MR. CONNELLY: Was that done in September of 1985?

MR. TOM: September of '84.

MR. CONNELLY: Of '84.

MR. TOM: Yes.

MR. CONNELLY: Were there any other shares other than those issued through the management?

MR. TOM: No.

MR. CONNELLY: What's the basis of consideration for the half million dollars that went to management?

MR. TOM: For services rendered. For, you know, in lieu of bonuses. For example, the half million dollars, and for the details of this, unfortunately the foundation was not asked to appear --

MR. CONNELLY: Right.

MR. TOM: And I'm sure that they could elaborate on this more, but based upon the minutes and the footnotes of the financial statements, the 55,000 shares was issued as compensation for services rendered, there was an entry made to reflect that in the same way, that cash compensation would have been --

MR. CONNELLY: Was that guaranteed earlier in time, in other words, was there anything earlier in time, closer to the date of conversion where stocks exchange without direct financial consideration. Or an agreement entered into? Are you aware of anything like that?

MR. TOM: No. No there was none.

MR. CONNELLY: The $7.65 price. That was prior to the public offering as well, is that --

MR. TOM: Yes sir.

MR. CONNELLY: That was what, about a year and a half prior?

MR. TOM: That was in September of 1984, the offering, the common stock offering was what, May of 85? May of 85. So it's -- yeah, about eighteen months.

MR. CONNELLY: You answered earlier and I got lost in the numbers, but, in terms of dollars, just roughly, how much of those options were exercised, by the management folks.

MR. TOM: Now you're talking about -- you mean of the million six thousand shares under stock option?

MR. CONNELLY: I think so, that's the last increment, right?

MR. TOM: No, that was the one I talked about --

MR. CONNELLY: That's the $7.65 --

MR. TOM: The $7.65 --

MR. CONNELLY: Yes, um-hmm.

MR. TOM: That one, the number of shares that have been exercised is 302,400 shares --

MR. CONNELLY: Do they still have an option on the other shares? Of those --

MR. TOM: On some of the shares, I believe so, yes.

UNIDENTIFIED: At $7.65.

MR. CONNELLY: At $7.65.

MR. TOM: At $7.65, yes.

MR. CONNELLY: So that's, what is that, I'm just trying to think, that's the $2 million figure you gave earlier, just roughly.

MR. TOM: Yes, I guess so, right.

MR. CONNELLY: Yeah, that were exercised, they're worth 7 million now.

MR. ROBINSON: How many have expired, is the easiest way --

MR. TOM: Three hundred twenty two thousand.

MR. ROBINSON: So it's fifty-fifty on -- and then, so what you've got --

MR. TOM: So it's six hundred and something thousand altogether, of which 300,00 have been --

MR. ROBINSON: And how much are still outstanding?

MR. TOM: Up to 300,000 roughly.

MR. ROBINSON: We can pretty well safely, give the current market, that those are going to be exercised, so its about two to one. If they don't want to exercise them, I know some people that would.

CHAIRMAN McALISTER: Perhaps we ought to recess for lunch and we'll come back at, well, two o'clock.

MR. TOM: All right. If you would like, Mr. McAlister, I might kind of conclude this story that there is you know, another phase to it so we can conclude this part of the agenda.

CHAIRMAN McALISTER: How long have you got?

MR. TOM: It would be less than five minutes.

CHAIRMAN McALISTER: All right. Go ahead.

MR. TOM: There has been reference made to the public offering. I wanted to touch base on that because I think that will be relevant for future discussion.

There was a public offering in May of 1985 and this occurred after the two and a half for one stock split. In that offering, 1,750,000 shares were issued at $10 -- or sold at $10.25 a share. As part of that offering Sierra sold, this is the charity now, sold 950,000 shares, securing thereby net proceeds of over $9 million.

Now, I think that we should look at what the -- what Sierra Foundation for Health derived in this transaction. First, it derived the two and a half million pre-split shares of Americare.

Second, because we were concerned that the Foundation have as its only asset that stock and no cash, the Foundation agreed to pay and did pay over $1 million, which is why there is that $1 million number over on the side there, in addition to the stock.

So, at that date, they got a million dollars, the Foundation got a million dollars, the charity got a million dollars plus all of the stock.

MR. JOHNSON: I think it would be helpful if, from now on you could refer to one as charity and one as Foundation, it's a little difficult --

MR. TOM: All right, the charity received a million dollars plus two and a half million shares of Americare stock. There was another transaction I didn't mention because it's relatively immaterial, in which the charity sold some of its shares, it was a modest number, 54,000 shares, I think it was, back to the Health Plan for $11 a share pursuant to a contractual agreement, and received a $600,000 payment therefor, so it now has a million six, plus almost two and a half million shares of stock.

Then it sold 950,000 shares in the public offering for $9 million. So at that point it had derived $10,600,000 in cash, plus it still owned about 1,500,000 shares of stock.

MR. SEASTRAND: Pardon me, didn't they split the shares prior to this? If they had two and a half million, they would have had 7,500,000.

MR. TOM: I keep falling into that, I'm glad you're here to --

MR. SEASTRAND: So they would have had six and a half million shares left valued at $10, they're worth $60 million.

MR. TOM: You are correct, I undervalued it. They have over five million shares of stock, so just to summarize so that we can close, Mr. Chairman, Sierra, the charity, achieved a million up front, six hundred thousand in the redemption, $9 million in the public offering, plus it still has 5,254,370 shares worth in excess of $50 million based upon the current fair market value. That's what this charity received for this conversion. And I --

MR. SEASTRAND: Based on the market value, we won't say the fair market value.

CHAIRMAN McALISTER: Those five million shares, of course, cannot be sold.

MR. TOM: Only over a period of time.

CHAIRMAN McALISTER: Twenty percent a year for five years.

MR. TOM: Yes.

CHAIRMAN McALISTER: All right, any questions? All right, we'll adjourn until two o'clock.

MR. TOM: Thank you.

(Thereupon the lunch recess was taken.)

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CHAIRMAN McALISTER: (Inaudible) to start, except Mr. Connelly and I are the only members here. It would be nice if we had some other members.

Our first witness this afternoon -- all right, we'll call Mr. Jim Schultz from the Consumer's Union.

MR. SCHULTZ: Mr. Chairman, Assemblyman Connelly, Jim Schultz representing Consumer's Union, publishing Consumer Reports Magazine.

First of all, we want to thank you for taking time to hold this hearing, and all the members and staff who put time into it, to look into what we think is an issue of significant interest to health consumers in the State of California.

Consumer's Union supports the concept of health maintenance organizations by putting the burden of cost containment on providers. Health maintenance organizations have permitted more than six million consumers of health care in California to benefit in the form of lower health care prices at a continuous rate.

What we're concerned about is the method by which these

HMO's have been converted. We're concerned about the following things: Number one. While the Knox-Keene Act requires, as an intention of it that -- while the Knox-Keene Act states that it is the intent to hold the cost of health care as low as possible to consumers, the Department of Corporations does not include in its conversion process an assessment of how the cost to consumers will be affected by the conversion.

Second, we believe that the charitable trusts are entitled to the full assets of the converting health maintenance organization. We talked earlier this morning about profit making on the assets of the corporation and about the ability to make a profit by assuming the risk of a corporation.

The risk of creating health care maintenance organizations was assumed by your constituents, by the people of the State of California and other states, by providing start-up capital in the form of federal grants.

The people of the State of California assumed the financial risk to their tax dollars of starting health maintenance organizations, and therefore, we believe that they are entitled to the full assets of those health maintenance organizations at the time of conversion.

The two cases here raise significant policy questions about the nature of those conversions, and whether those full assets were given to charity.

We have in Southern California a case where the stated market value used in the valuation, used in the conversion that determine how much money will be dedicated to charity is more than $10 million less than what another health care provider was willing to pay for those same assets. This raises serious questions as to whether or not the fair market value is really determined by the valuation methods used by the Department of Corporations.

There are a lot of issues, numbers, and questions involved in this, and you'll be spending a lot of time this afternoon going through those. The main questions we would like the committee to focus on, then, are whether the charitable trusts are indeed receiving the full benefits.

Whether the stock options created by the managers of the non-profits for themselves are derived from the charitable trusts, and whether the charitable trust is in fact receiving the full value that it's entitled to.

We have filed a petition with the Commissioner of Corporations requesting the following. Require applicants to clearly document the need for conversion. We've requested them to adopt clear procedures to assure that the sale price of the converting plan reflects its full market value.

There is no reason that the Department of Corporations should be able to value an HMO and then find out later that the valuation it accepted was so far below what the market has sold the shares for that HMO, and we think that the valuation procedure should be more clearly spelled out, in terms of what the sale price of that HMO would be in incorporating that into the assessed value of health maintenance organizations.

In addition, we want the Department to consider adopting regulations which will prohibit self-dealing and conflicts in which the managers of HMO's that are responsible for the stewardship of a non-profit corporation are allowed to make the choices that determine how much those charitable trusts are going to receive. We think that these deserve more careful scrutiny by the Department, and we appreciate the Committee's attention.

CHAIRMAN McALISTER: All right, thank you. Any questions, Mr. Schultz? All right, thank you. At this point in time we are going to watch a video presentation.

The FHP, Inc. controversy came to our attention through a series of news articles. In response by telephone and by letter we afforded the Corporations Commissioner an opportunity to respond. During the preceding two days, a two-part television investigative report was aired involving Foundation Health Plan, as with the case study of FHP, Inc., the issues involving company valuation, self-dealing transactions, and charitable distribution plans have arisen over Foundation Health Plan's approved conversion.

In order to provide the members and the Corporations Commissioner and his staff full opportunity to respond, I intend to now have us view and hear first hand the two-part investigative report. Do we need the lights out? Not for television. All right.

(Thereupon a video tape program was shown:)

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MR. JIMENEZ: Health care isn't big business, it's enormous business -- a staggering $350 billion a year business. That's more than $1400 for every man, woman, and child of us.

To cope with this, most of us here belong to health maintenance organizations, or HMO's as they're known. Most people choose a non-profit HMO, one designed to save money for the members instead of earning money for the owners. In a non-profit plan, nobody gets rich.

This story is about one of these non-profit HMO's called Foundation Health Plan -- and this man, George Deubel, Foundation's president. This is the story of how George Deubel used a non-profit plan to get rich.

Back in the 1970's George Deubel started Foundation and kept it gong by reaching for millions in government loans and tax breaks Congress made available only to non-profits.

By 1983, Foundation was a big success. It had so much money left over at the end of the year that it could have been the most profitable health plan in California -- if it could make a profit.

Let's stop now to understand a key rule. Non-profit health plans were set up with taxpayer dollars, which means they belong to their members -- you the public. Not the managers or board of directors.

Now, non-profit health plans can switch and become for-profit health plans. To do this, they have to satisfy state law, and the most important state law of all is this -- that the new owners pay a fair price for the non-profit health plan. And they pay that money to a charity.

For Foundation Health Plan, the historic day was February 3, 1984. On that Friday, George Deubel used three different corporations to transform Foundation into a real moneymaker.

Here's how he did it.

First, he told the state regulators that Foundation was worth $10.6 million.

Then, instead of finding an existing charity to give the money, George Deubel created a charity called Sierra Foundation for Health.

Then instead of giving this new charity $10 million, he gave it only $1 million, issuing stock in the health plan to cover the rest.

Then in the final step -- a stock swap -- George Deubel had his charity trade the health plan to a brand new company he headed, called Americare.

This insured that George Deubel and Americare -- not the charity -- would now control Foundation Health Plan.

So late Friday, George Deubel was on his way to becoming the principal voting shareholder in what is today a $92 million health plan and he hadn't spent a penny of his own money.

In fact, the conversion took only a few strokes of the pen, as revealed in this amazing document signed by the man who was president of all three corporations: George Deubel -- George Deubel -- George Deubel.

Three questions now:

Number one: Did Deubel tell state officials what Foundation was really worth?

Two: What did George Deubel get out of this deal?

Three: What did the rest of us get?

Economist Eric Schlesinger is a leading specialist in HMO's.

MR. SCHLESINGER: You could say the value of the company should have been something between 40 and 90 million dollars.

MR. JIMENEZ: Target 4's Brian McTigue asked George Deubel how he came up with the much lower value given state regulators, $10.6 million.

MR. DEUBEL: We had evaluations made, we presented the evaluations to the Department of Corporations.

MR. McTIGUE: Who did your evaluations?

MR. DEUBEL: We used Price Waterhouse, which is our audit firm. Along the way we used Bank of America --

MR. McTIGUE: We've looked at the Department of Corporations file, and there's no evaluation from any outside independent appraiser. There's no evaluation from the Bank of America. Did you really give them the evaluation from Bank of

America?

MR. DEUBEL: I don't recall --

MR. JIMENEZ: Target 4 has learned that the bank's estimate ranged from 16 to 19 million dollars -- almost twice what Deubel told the state the health plan was worth.

MR. McTIGUE: Why did you not give them the Bank of America evaluation, which was much higher?

MR. DEUBEL: Because we felt the 10.6 was more in line with our true evaluation of the company at that point in time --

MR. JIMENEZ: Deubel told us he had other estimates below 10 million --

MR. DEUBEL: They could have seen other evaluations which were lower.

MR. McTIGUE: Would you give me a copy of your lower evaluations?

MR. DEUBEL: No.

MR. McTIGUE: You won't? Is there a reason why you won't?

MR. DEUBEL: It's private documentation.

MR. SCHULTZ: George Deubel went from being a manager who was on salary with Foundation to being a big owner of Foundation. That's a real step up.

MR. JIMENEZ: Today, George Deubel is the largest voting shareholder in the company. And here's how he did it.

First, on February 3rd, the day Foundation became for-profit, George Deubel got 62,500 free, "bonus" shares of stock --

stock worth more than a half million dollars today. Why did he?

MR. DEUBEL: The reason for stock options, for bonus shares, for any kind of award is based upon future contribution --

MR. JIMENEZ: But the company's own by-laws allow payments only for "services actually rendered."

And in the last 18 months -- thanks in part to Deubel's own low estimate of the health plan's value -- he's acquired stock options worth another two and a half million dollars.

Deubel says the public will profit through the stock owned by the charity that he created --

MR. DEUBEL: Now, unless that stock goes to hell in a breadbasket, they're going to get a significant amount of money for that stock.

MR. JIMENEZ: But Consumer's Union sees it another way --

MR. SCHULTZ: So Sierra Foundation for Health, that was entitled to the full value of what that health plan was worth, only got a part of it.

MR. JIMENEZ: Lower premiums?

MR. SCHULTZ: They could have turned around and given every subscriber $150 off on their health plan. They could have cut the price from $850 a year to $700 a year, but they didn't do it.

MR. JIMENEZ: Why not?

MR. SCHULTZ: It is certainly more profitable for the managers to do what they did and become private sector and sell it to themselves.

MR. JIMENEZ: These health profit conversions have become a major trend. In fact, in just a year and a half, 124 plans nationwide have converted from non-profit to for-profit, making money. That's a third of all the federal health plans in this country, and a lot more may follow their example now, with a small number of individuals making a huge windfall profit.

MS. ABRAMS: Bob, at this point, do you know which state officials approved Deubel's plan?

MR. JIMENEZ: The people, Roz, who work for the State Department of Corporations. That is why on Wednesday, in the morning, two committees of the State Legislature will start these hearings to determine exactly what went wrong -- which brings us to tomorrow night, part two of our cover story.

In fact, we're going to show you much of what the state legislators will discover, including the story of how one legislator raised questions. And the state let Mr. Deubel himself supply all the answers.

MS. ABRAMS: Health care has become big business with a lot of guaranteed customers. It's become the fastest rising part of our cost of living. Now many non-profit health plans which were created to keep costs down are being converted into companies designed to make money.

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On Cover Story tonight: How you will be affected as health-care changes from a service to an industry.

MR. PAYMAR: Who wins and who loses when your non-profit health plan decides to start earning money? NewsCenter 4's Bob Jimenez and the Target 4 Unit have been investigating the conversion of the Foundation Health Plan. And what they've uncovered has helped lead to legislative hearings starting tomorrow in Sacramento. Here's part two of their report.

MR. SCHULTZ: In about three different ways the taxpayers have lost a lot of funds by having Foundation become for-profit.

MR. JIMENEZ: Because non-profit health plans are created with tax breaks and public money, the Legislature decided that the public must be repaid -- in full -- whenever one of these plans starts trying to make a profit.

MR. SCHULTZ: The assets don't belong to the management, the assets don't belong to the board of directors. They belong to the public and the public's not getting it.

MR. JIMENEZ: Case in point: Northern California's Foundation Health Plan, which went for-profit last year after giving $10.6 million in cash and stock to a charity created for the change-over.

But Bank of America estimated that the company was worth almost twice what the new owners paid. On the stock market, the company is already worth more than five times that price.

MR. SCHULTZ: What went wrong is they gave the people who were in the position to make a profit off the conversion an incredible amount of control over setting the price that they were going to have to pay to buy this. They allow these kinds of conflict of interest to just go unchecked.

MR. DEUBEL: We had evaluations made. We presented the evaluations to the Department of Corporations and they accepted it.

MR. JIMENEZ: The Department of Corporations is charged with getting a fair price for the public charity whenever a health plan changes to profit-making status. Richard Camille is in charge of that process --

MR. CAMILLE: We would ask for all of the figures that they have. I'm sure we would ask for every piece of information that they have.

MR. JIMENEZ: Target 4's Brian McTigue asked whether Foundation Health Plan showed the state the much higher value Bank of America gave it --

MR. McTIGUE: They did a Bank of America evaluation?

MR. CAMILLE: Don't know.

MR. McTIGUE: You don't?

MR. CAMILLE: No, I don't.

MR. McTIGUE: As high as $19 million and you didn't see it, would that make you quesion?

MR. CAMILLE: Yeah, we'd like to have seen that, sure.

MR. McALISTER: I would thank that even today, under any law that exists, that concealment of evaluation would raise very serious legal questions.

MR. JIMENEZ: Alister McAlister is chairman of the Assembly Finance and Insurance Committee that opens a hearing tomorrow on how non-profit health plans change to for-profit.

MR. McALISTER: We are not going to tolerate, simply, allowing people to hide, or obscure or conceal evaluations.

MR. JIMENEZ: When Assemblyman Lloyd Connelly questioned the Department of Corporations about how they handled the deal, the state let the health plan itself give him the answers.

MR. CONNELLY: The inquiry was actually routed through the Foundation Health Plan people and their attorneys. So as a response to an inquiry to the Department of Corporations, I got a very lengthy letter from the corporation I was making an inquiry about.

MR. JIMENEZ: Today Connelly is calling for a change in the law --

MR. CONNELLY: The most important change in the law being a prohibition on insider trading, that is, that a non-profit corporation cannot sell to themselves that corporation to turn it into a profit making body and in that transfer frequently make substantial earnings.

MR. JIMENEZ: With the Target 4 Unit, Bob Jimenez, NewsCenter 4.

MR. PAYMAR: The new owners promise that the change will hold down premiums for the health plan's customers -- but instead, premiums have gone up. Today, Consumer's Union filed an administrative lawsuit to stop any more health plan conversions, and tomorrow in Sacramento two Assembly Committees will open hearings on the big trend toward for-profit health plans.

MR. McTIGUE: Tomorrow on our cover story we take a different look at the business of health care.

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CHAIRMAN McALISTER: All right, thank you. We're going to vary our agenda just slightly here, because I think I'd like to have Jim Schwartz from the Attorney General come up and we'll -- I think we'll hear from Mr. Tom after him.

MR. SCHWARTZ: Good afternoon.

MR. McALISTER: Yes, thank you. Go ahead.

MR. SCHWARTZ: Well, I was asked by Mr. Bianco to basically try and explain, because he thought that there was some uncertainty with respect to the Foundation Health Plan valuations and stock split materials that were provided just before the break.

I told him I'd be happy to do that. I should tell you that we have not anywhere near completed our investigation into the charitable aspects of the Foundation Health Plan matter, and I really would prefer not to comment on those. With respect to the valuation and the appreciation on the shares, I think it's more easily understood if we look at both pre-split and post-split scenarios.

Before the split Sierra Foundation had 2.5 million shares of Americare, as I understand it, and there was an additional 1.2 million shares that were available for options to the officers, directors, and providers, for a total of 3.7 million shares. Assuming a value of 19 million dollars in the company, each share of stock would be worth approximately $5 a share, slightly more.

Assuming that you pay fair market value when you exercise the option, I don't think you have a problem with respect to windfall. That is, if the person who buys the option share pays fair market value for it, no problem is created, the company has got the assets, and no harm is done.

If they pay substantially less than fair market value for the options, then you do have a problem. If you look at the post split, which happens very soon thereafter, you see that Sierra Foundation then holds 6.3 million shares.

CHAIRMAN McALISTER: How many is that again? Six point three?

MR. SCHWARTZ: Six point three. That's a two and a half to one stock split. There's three million shares now available for option.

Theoretically, the value of the company a few months later should be worth approximately the same thing. The shares have a lesser value, but in fact each party's interest remains proportionally the same. The company then goes public. And I assume that it was always intended that it would go public. And it goes public at a price of $10 per share on the split share.

So the shares that originally cost the officers and directors basically $3 a share are now selling for $10 a share.

Now, I think that the crux of the problem is the appraisal that you are dealing with. You have a $10 million appraisal, you have a $20 million dollar appraisal. What you may not have, and I don't know because we haven't seen the records, but you may not have an appraisal that takes into consideration comparable values in the stock market.

That is, if you do a comparative analysis, which is one of the methods which was used by investment bankers and they talked about it earlier. If, in fact, you use that methodology, what you'll find at certain points in time is that these companies go public for a certain price/earnings ratio, and in this case I think they go for about 20 to 22 times earnings on average, some less, some more.

When you use a 20 percent cap rate, you're basically using a 5 times earnings ratio. So in effect you have a built-in differentiation between those two audit methods of four times, and that's where the problem that Mr. Connelly was concerned with, and the problem that Mr. Bianco asked me to comment on, that's where that's created. It's a difference in valuation methods.

Any time you do not use a -- or do not recognize an appraisal method that takes into consideration what the market will pay when you offer the shares in the public domain, then you have that built-in problem.

CHAIRMAN McALISTER: Well, as a matter of fact, we do have here documents, I think we've handed them out to members, headed The Americare Health Corporation Restricted Stock Valuation, which apparently consists of evaluations made by the Bank of America. I believe that's so. Isn't that true, Mr. Bianco, these were from Bank of America.

MR. ROBINSON: It's a law firm's letterhead -- are we looking at the same document?

CHAIRMAN McALISTER: Well, no, this is --

MR. ROBINSON: You mean it's dated October 18, 1983?

MR. BIANCO: We're talking about the August 3, '84.

MR. ROBINSON: Okay, well I don't -- okay, go ahead, I was just looking at the wrong form.

CHAIRMAN McALISTER: This purports to be a valuation as of 3/31/84 which is getting pretty close, it's less than seven weeks after the conversion. And, at pages five and nine and thirty-three and thirty-four of this document, they go into the public market price, or public/company market price, and they indicate on that basis that the value would have been from 60 to over $65 million.

They state at page 20, page 33, based on market price book value multiple of five, they indicate a public price, a public market price of $65,650,000. That is, of course, the highest value of the various forms of valuation -- they went through a variety of valuations.

They have one here, of -- well they have that one, they have a growing concern value which they set at $26 million, a book value of $13 million, a liquidation value of $16 million, an acquisition value of 25 to thirty-three and a half million, and an investment value of $25 million. Mr. Johnson.

MR. JOHNSON: I still haven't heard an answer to the question Mr. Seastrand asked before the lunch break, and that is -- didn't the charity created, Sierra Foundation, wind up with just as much money and stock, the value increased for them as much as for the directors and operators of the foundation plan?

MR. SCHWARTZ: Well, the answer to that really and simply is no they did not. The charity originally had 100 percent according to testimony. That 100 percent, however, is really a fictitious amount.

MR. JOHNSON: The 100 percent was conditioned by the options available on on 30 percent from the beginning, as I understand it.

MR. SCHWARTZ: You are absolutely correct. And so in effect, the deal that they made was to end up after all the hoops were jumped through, with 70 percent in Sierra Foundation, which is the charity, and 30 percent remaining in the company available for the option. Right?

That is, 30 percent doesn't go out, I don't think originally anticipated in gifts to anybody. But 30 percent of the stock is supposed to be purchased at fair market value as of the date of the option. That's what I understand the testimony to be.

Now, if that's the case, and if the stock is purchased at fair market value, you are absolutely correct, that no one loses anything. And if the options are purchased at below fair market value, then, in fact, the charity's interest is diluted, because in fact, stock, the company's -- the charity's holding 70 percent of the value in the company, and that 70 percent is worth less because somebody is buying stock for below market.

But the key answer to your question is that company, is Americare, which is the holding company, getting fair market value for its stock when it sells the option. If it is, we have Mr. Seastrand's -- it's right, we have no problem. If it's not, then we do have a problem.

MR. JOHNSON: Well, I guess I'm still siding with Mr. Seastrand.

MR. SCHWARTZ: Well, I'm not in disagreement with him. What I'm saying to you is that it all boils down to the question, when I exercise my option, am I paying fair market value for that share of stock that I'm getting.

If I am, then the company is receiving a fair value for the part of the gift that it is selling. And if I am paying less than fair market value, and I'm the company, I'm selling, then I am not getting fair market value, and therefore the value of my company is being diminished.

CHAIRMAN McALISTER: There's another question I have here --

MR. ROBINSON: I was still waiting from before --

CHAIRMAN McALISTER: What's the legality of giving free stock to Mr. Deubel?

MR. SCHWARTZ: I can't answer that question, I'm not a securities lawyer.

CHAIRMAN McALISTER: I wasn't aware you could ever give free stock away. And certainly not for so-called future services. I mean that, that may have been a misstatement, but -- and I don't know -- if it were for past services, that's by definition impossible.

I mean, you know, Americare didn't exist until February. There are no past services. There are 62,500 shares of stock not sold for $7 or $3, but apparently given.

MR. SCHWARTZ: I'm not prepared to answer that because I don't know the answer to begin with.

CHAIRMAN McALISTER: All right, Mr. Robinson?

MR. ROBINSON: I'm sorry, I didn't get your name.

MR. SCHWARTZ: Jim Schwartz.

MR. ROBINSON: Mr. Schwartz. You're with the Attorney General's office, is that correct?

MR. SCHWARTZ: That's correct.

MR. ROBINSON: And I understand that you have this currently -- you're in litigation, or -- and using most of the facts that you've heard as a hypothetical, and if the testimony was at $7 a share or something upon execution of the options, the pricing which you went into in your initial testimony, 22 to 1, or 20 to 1, or something around there.

If it was envisioned in fact, that they were going to go public. If it were envisioned, in fact, that the 30 percent set aside for options and whatnot was there, and if there were other valuations made, whether by the big eight accounting firm -- I won't mention names -- just the big eight accounting firm as well as a reputable bank, they were in excess of what was on the documents filed with the Department of Corporations.

Wasn't there a burden on the state or the applicant to supply all of that relevant data to the corporations, and would that not, legally I mean, should there have been some weighing of the market value of that stock based on an historical performance of like issues in determining evaluation?

MR. SCHWARTZ: In fairness to all the parties, the law currently provides the Department of Corporations with the discretion to evaluate the conversion. We --

MR. ROBINSON: Would that include the potentiality -- if the deal as presented, or through their investigation, they learned that as part -- as it was envisioned originally, that this was going to go public, after they went through this pyramid of corporations, they were going to go public, shouldn't that reasonably be expected to weigh in on the valuation of the --

MR. SCHWARTZ: I would personally weigh it in.

MR. ROBINSON: I am asking you personally, I'm not asking you to put the Attorney General on the hook, or --

MR. SCHWARTZ: If I were dealing with valuation. With valuation data, as you heard the Shearson/Lane representative earlier, when you have a proposal that the company is going to go public, one would think that you would use a mechanism that took that into consideration, and I believe that the Bank of America valuation actually does take that into consideration.

MR. ROBINSON: Okay, and furthermore, and this is my final question because I have not seen the red hearing, or the prospectus on this when they went public --

CHAIRMAN McALISTER: Mr. Robinson, before you proceed, can I ask the witness to pull the microphones a little closer to him?

MR. ROBINSON: Okay, certainly. But, if in fact, there was substantial or material difference between the S1 filing, the subsequent red hearing, and the final prospectus as approved by the FCC as to the valuation of the company, would it not put the public at a disadvantage over the managers of the -- I said if, in fact, this is the case, -- over the managers that took this company from a charitable, I mean, from a non-profit to a profit corporation?

MR. SCHWARTZ: I would assume so.

MR. ROBINSON: And I use -- being so members of the public can understand what I'm talking about, I mean, if, for example, the S1 appears to have a valuation of $19 million, I understand that that was subsequently deleted from both the preliminary red hearing, as well as the prospectus. And the public had less information -- that purchased the stock.

MR. SCHWARTZ: Virtually by definition they did, that's right.

MR. ROBINSON: Right. Thank you, Mr. Chairman.

CHAIRMAN McALISTER: Mr. Elder.

MR. ELDER: I'm just curious. You're with the Attorney General's office. Has the Attorney General's office developed an appraisal methodology that it likes?

MR. SCHWARTZ: We don't -- we no longer do this. We are in the process of litigation in the Los Angeles Superior Court case. We, in effect, will hire, and have in that case hired, an expert appraiser. That is, we don't have the, the expertise within our office --

MR. ELDER: All right, so you're not offering a professional opinion as to the value.

MR. SCHWARTZ: That's exactly correct.

MR. ELDER: All right, and the Corporations Commissioner has, is not up here, but as far as you know, do they have a -- do they have an approved methodology?

MR. SCHWARTZ: I don't know the answer to that.

MR. ELDER: You don't know the answer to that. Okay. All right, and the law permits currently that someone in the Corporation Commission has the authority to set the value from the standpoint of going from non-profit to for-profit. They're following the law. These people have been --

MR. SCHWARTZ: We have a difference of opinion with them on what the law requires as it relates to self-dealing transactions. We think that the new non-profit Corporations Code has provisions that are not being followed.

MR. ELDER: All right, then, you know I have a real concern when, you know -- one of my feelings about the stock market is, you know, don't go broke, go public, I don't really view the stock market as a particularly good indicator of what reality or value is -- it's more or less what some people will pay in the hope of making an excessive profit at some point in the future under the advice of someone who called him on the phone and tried to sell him the stock.

So, I mean, that's not -- when you're talking value, you're not talking an MIA appraisal -- Bank of America -- now Bank of America has a little appraisal problem too, I mean, you may know about.

They sold their building for $500 million, $600 million, and they're maintaining that it's really only really worth $137 million for assessment purposes. So I think they've got a -- I don't know, maybe that was after this fine report, but the people of San Francisco are going to be losing $5 million a year forever in property tax revenue, which goes for paramedics and police services, which are not charitable operations, but theoretically have some, you know, human value, and if these people don't make money, will they ever sell? I mean, why would you do that? Why would you be motivated to go into a transaction where you were going to break exactly even or lose something. And if that happens, how are the charities ever going to be benefited?

MR. SCHWARTZ: Well, the charity -- the charity is the health plan, you see. When you start, FHP, Inc. is a charitable corporation.

MR. ELDER: FHP has nothing to do with Family Health Plan in Southern California, which I understand is what your lawsuit is against. You are using the FHP -- the same --

MR. SCHWARTZ: No -- let me go -- Family Health Program, Inc. has changed it's name to FHP, Inc., the Southern California --

MR. ELDER: All right, we're not talking about the same --

MR. SCHWARTZ: Foundation Health Plan in Sacramento is a different one.

MR. ELDER: Good. I want to be clear about that.

MR. SCHWARTZ: It has been our feeling that the law requires not the Department of Corporations, but the independent directors of the charitable corporation under 5233D of the Corporations Code, to obtain the most advantageous deal they can if they choose to sell those assets.

Now, remember, we don't insist that they sell them. Quite to the contrary. It's really not our business whether officers and directors choose to sell a business or not. And whether they choose to sell to themselves or not. All we ask is that they obey the law if, in fact they do decide to enter that transaction.

MR. ELDER: An arm's length appraisal --

MR. SCHWARTZ: Well, no, the test under 5233D is fourfold. Subsection B says it shall be fair. That applies to all charitable corporations, whether it's a self-dealing transaction or not. When you have a self-dealing transaction, you have an additional requirement. And that is that the independent directors determine that this is the most advantageous deal that can be made.

When the bill was going through it was colloquially referred to as the "Best Deal in Town" provision. That was meant to be an additional layer of protection when we eliminated the strict prohibition against this. So that in an insider dealing we would have more than just the fairness test, we would have the best deal in town test.

The case law seems to indicate that the only realistic way of determining the best deal in town is a market test system. That is, I'm a litigation attorney, I can go out and hire appraisals whether I'm doing condemnation work, or whether I'm doing business valuation work, or whatever I'm doing, and those appraisals will differ tremendously, depending on what I tell the appraiser and what I want.

If, in fact, I have to test the market, I will find what a willing buyer is willing to pay, and that's perhaps a little better test, because we have somebody actually willing to put up cash money.

MR. ELDER: Well, it seems to me that the obvious, one of the things that should be explored is having corporations get the external appraisal. All right, and if that's done, then, you know, it's not a self-dealing appraisal.

MR. SCHWARTZ: That's a far better way. In other words, if you have an independent -- if you have --

MR. ELDER: I mean even if these people have to pay for an appraisal, which I don't think corporations should have to pay for -- that seems to me would clean it up tremendously.

MR. SCHWARTZ: Well, I think that that's an exceptionally good suggestion, in fact, what you will then have is you will have arm's length dealings. You will have negotiations between two separate parties who have theoretically, at least adverse interests. One trying to get a good price, one trying to get the best price they can. There's nothing wrong with the buyer trying to get the best price he can --

MR. ELDER: Absolutely --

MR. SCHWARTZ: As long as you have a seller trying to get the best price he can also.

MR. ELDER: I know that your testimony is directed at trying to get improvement in the law in the current situation, and I think that in fairness to everybody there needs to be certainty as to what everybody's responsibility is, and -- and I think that that might be a really good way to handle it is to have a separate appraisal run independently and contracted for by the Department of Corporations.

And thus, even paid for by the parties, but billed directly to corporations so that the corporations get the money and so there is not a client relationship between the MAI appraiser, or whatever you're going to use, as to the value. And, in that case, there is no question of instructions, if you will, or made as instructed appraisals, or MAI as they are officially known, but rather they will be arm's length, paid for out of the process by the people who are trying to make the change, but the money paid directly to corporations, who then hires the appraisal persons or firms.

I think that's a much cleaner way to handle it, and it would give certainty to the process and eliminate the appearance and probably the fact of where it looks like a windfall is being made by someone.

MR. SCHWARTZ: I don't disagree with you. I think that the important thing is to have somebody representing the seller, who is trying to maximize the return to the seller. And if you have that, and you have the buyer looking out for themselves, the market should take care of it.

CHAIRMAN McALISTER: It seems to me, Mr. Schwartz, that your view of the duty of the -- what shall we call him, the charitable trustee, I guess, to maximize the returns to the charity is the traditional and long-standing view of charitable trusts, and indeed it's the -- isn't it the law applicable to any trust?

MR. SCHWARTZ: We do believe that's correct.

CHAIRMAN McALISTER: That the trustee has that duty.

MR. SCHWARTZ: He's a fiduciary and he has a duty to the trust, a duty of loyalty to the trust, and a duty to maximize the trust's interests in all cases.

CHAIRMAN McALISTER: Okay. It makes all this business, all this inside dealings always rather suspect, doesn't it?

MR. SCHWARTZ: Well, of course, if I go back in time before the change in law, we didn't allow self-dealing. Now we do, but we built in the safeguards.

The feeling was that if the safeguards were rigorously enforced and rigorously adhered to, that would provide us an adequate mechanism of protection. Obviously if they're not, we don't think we have --

CHAIRMAN McALISTER: But there's an internal and almost inescapable conflict of interest. You've got to watch it very closely, don't you?

MR. SCHWARTZ: That's correct.

CHAIRMAN McALISTER: I mean --

MR. SCHWARTZ: Whenever you have self-dealing you have a conflict of interest. That's what the term means.

CHAIRMAN McALISTER: Sure.

MR. CONNELLY: Can I ask -- I heard part of your testimony on the box downstairs, but this is on the valuation issue, and your comments on the fair market value were very helpful.

In your opinion, were the stock options as exercised by Sacramento Foundation, the purchase price at that time, reflective of the fair market value?

MR. SCHWARTZ: I can't tell you that I'm prepared to answer that because I'm not a valuation expert in the first place, and in the second place I haven't seen all the appraisal information that's come in.

What I said before was quite simply that I think that when you do a valuation, where you're going to have a stock offering, when you anticipate that -- that you must take into account, from what our experts have told us, what that stock will yield on the market.

That is, what the company is worth to investors who are now going to be asked to pay for it. And, if you do that, I think you have a much better chance of getting fair market value. If you simply use an appraisal that ignores that factor, or doesn't take it into account, or significantly discounts it, then you have a much higher probability of coming up with a value that doesn't reflect what the market is going to pay for the stock.

MR. CONNELLY: Let me ask this question. A day after conversion, this is a hypothetical question, the new profit-making corporation made up of the old officers and directors of the non-profit corporation, vote themselves a million dollar bonus, a day after the conversion, or two days after the conversion. Are they violating any law when they do that? And they are taking those assets from the existing corporation.

MR. SCHWARTZ: I can't answer questions regarding what's legal under securities law --

MR. CONNELLY: Right.

MR. SCHWARTZ: Because I'm not a securities lawyer. The Security and Exchange Commission people will give you a better -- better opinion on that. Ah, my area of expertise is charitable trust law.

CHAIRMAN McALISTER: Our next hearing can either be in Washington, D.C. or they can come out to see us. Whichever is most convenient.

MR. CONNELLY: Thank you.

MR. JOHNSON: Better them than us, Mr. Chairman.

CHAIRMAN McALISTER: All right, thank you very much -- Mr. Johnson has --

MR. JOHNSON: Yes. Just to -- following up on Mr. Elder's question with respect to independent valuations in the case of HFP in Southern California as opposed to Foundation in Northern California, my understanding that that was the procedure that was indeed followed, that there was a mutual agreement that Earnston, when he would conduct evaluation, and that there were subsequent adjustments to that valuation by the Department of Corporations. So, isn't in that instance, wasn't Mr. Elder's suggestion followed?

MR. SCHWARTZ: I don't beieve so. I believe that while the Department of Corporations, as I understand the testimony agreed to that apprais -- to that accounting firm's view of the appraisal, what we would look for would be in effect a buyer's appraiser and a seller's appraiser.

That is, somebody trying to maximize value, and somebody trying to buy for the best price available. And then --

MR. JOHNSON: Okay --

MR. SCHWARTZ: -- trying to marry the two for value --

MR. JOHNSON: That next question, you know, is, I suppose, a very logical one, the maximization of value. And it seems to me, if I understand your testimony, your position, that is basically the only consideration, the maximization, and not necessarily of a sales price, or a charitable contribution, but rather maximization of a set valuation of the operation. Is that --

MR. SCHWARTZ: What I'm saying is that Section 5233D of the Corporations Code requires the fiduciary to attempt to obtain the most advantageous deal they can. If we hold the independent fiduciary --

MR. JOHNSON: Okay.

MR. SCHWARTZ: -- directors to that standard. Or if we replace the Department of Corporations in their shoes, but ask them to enforce that same provision, you will get a different conclusion than was reached in (unintelligible).

MR. JOHNSON: Yeah, yeah, I think that's really the crux of the debate here, how we go about defining advantageous. And the assumption in your testimony seems to be that that is a dollar amount that goes to a newly created charity, and I guess the flip side of that is the contention that there is an obligation to existing subscribers of the HMO, and to the ability for that future entity to be able to compete effectively in the overall HMO market.

MR. SCHWARTZ: Well, I'm a rather conservative human being. To be honest with you, I assume that the market takes care of that. That if I am a business entity out to make a profit, that I will not offer to pay more for a business than it's worth in the market. And if I make a mistake and pay too much, then my shareholders will bear the burden of that.

MR. JOHNSON: Yes, but in this case it's not just the shareholders, it's the people of California who need access to low-cost health care, and it requires no great leap of imagination at all, frankly on my part, and I'm known as a fairly conservative individual as well, it requires no great leap of imagination on my part at all to construct a scenario wherein one business entity under these circumstances would offer a price that is totally out of line with the value of a not-for-profit HMO in order to prevent competition on the one hand -- that is to say if the business is successful.

Or on the other hand, to prevent the conversion from not-for-profit to for-profit status, so as to put that not-for-profit operation at a continued competitive disadvantage. It requires no great leap of imagination at all.

MR. SCHWARTZ: I think one of the problems in the area is that we are not -- you know Kaiser is the largest in the industry, they are a non-profit. If you were dealing with people who had enormous market shares, I think that scenario could conceivably be the case, but we don't seem to be dealing with that. At least in the current state of affairs in California. That's not to say that that could never happen, but that doesn't seem to be a factor that's taking place right now.

MR. JOHNSON: Well, if one admits that that is a theoretical possibility, then it seems to me it follows logically that what we're saying is, that it would require a tradeoff, a balancing of factors in determining what is, in fact, the most advantageous price. That it can't be -- one cannot assume that the highest offer necessarily, is the most advantageous.

MR. SCHWARTZ: Well it's the most -- if it was your business, you'd want the best price for your company. We say that the fiduciary, whose duty of loyalty is to the charitable beneficiaries.

That's the law -- you know, I'm not making the law, that's the law in this state. That a fiduciary, a director of a non-profit charitable corporation, owes his loyalty, to the charitable beneficiaries, all right, which is basically the public. And that those folks are entitled to maximize their value. Now if we are going to have anti-competitive concerns, we can deal with those with the Federal Trade Commission, or through the anti-trust divisions. And they are in place, and my understanding is that you have to get approvals before you can acquire -- in the health plan industry, before you can acquire.

And that those anti-competitive tests would then apply and you may not be able to buy. If you have anti-competitive effects, then theoretically if those agencies are doing their job properly, they'll say no, you are not a qualified buyer, and then your offer will be meaningless.

If, in fact, you are a qualified buyer, and they decide that they are not anti-competitive effects, then, in fact, we think that those questions have then been answered and the charity can then sell, and it will get, in effect, the best value, and that money will of course, go into the charitable sector, and be used to benefit the people. And that's really what the law currently requires. Now, you may say, well, I don't think that that is the best solution, and I think that we should write into the statutes a mechanism by which these other considerations are taken into account. That is --

MR. JOHNSON: There are some who feel that we did, some years ago.

MR. SCHWARTZ: Okay, (unintelligible) that's correct.

MR. JOHNSON: Thank you very much.

MR. McALISTER: Mr. Schwartz, I wonder, would -- I, I guess some of the folks who want to defend the existing arrangements would say that you -- that if you enforce the charitable trust doctrines in their rigorous concept, that there probably wouldn't be any more conversions. That the people who are in charge of a non-profit health care plan would have no particular incentive to convert, and therefore, they wouldn't convert, um -- first of all, do you think that that is correct? That they would not con --

MR. SCHWARTZ: I can't answer that question. I don't know.

MR. McALISTER: Okay. But -- if that is so, if they wouldn't convert, do you think that is a good thing, bad thing, indifferent thing, or it doesn't matter.

MR. SCHWARTZ: Again, out of my area of expertise. I'm just a lawyer.

MR. McALISTER: Okay. I mean those are things it seems to me the committee is going to have to consider -- and, in -- in these cases it appears that the people who are the organizers of the non-profit organizations have come off extremely well -- I mean, just fantastically well. Maybe we ought to give people some kind of a finders fee, or something, but put some kind of reasonable limits on it. What if we gave them 5 or 10 percent of the value and restricted it to that -- that's out of your realm too,

MR. SCHWARTZ: Well --

MR. McALISTER: You think that -- would that offend, would that deeply offend the kinds of principles we're trying to defend, though?

MR. SCHWARTZ: I'm not deeply offended by asking people to pay the fair market value for a business, so I'm probably the wrong person to ask.

MR. McALISTER: Okay. Well, I think you're clearly right. I mean, I don't think any we law we've passed has changed that. It's just..beyond me how -- if you push your lawsuit far enough you're going to win. I mean, I think some court's going to say it's open and shut. Slam dunk. Whether that's a good -- you know, we could argue about that being good or -- or perhaps good but not totally good policy. There may be some room for some change. I have to say that I'm deeply troubled by these people coming off with these millions and millions of dollars of profit from converting a non-profit into a profit. I -- it may be as a practical matter they should get something, but it seems to me -- I'm troubled by them getting so much. Any other questions? Thank you. All right, Mr. Tom. Mr. Tom, before you start, let me ask you, I mean, how can Deubel take sixty-two and a half thousand shares, free shares?

MR. TOM: I don't know where the data for the Channel 4 presentation came from. I don't know where those particular shares that are referred to came from. I assume --

MR. McALISTER: Well, we have documents here that refer to that.

MR. TOM: -- that they were part of the 55,000 pre-split shares that were the subject of the issuance in September of 1984 for services rendered. We talked about -- we talked about that earlier.

MR. McALISTER: What services? What services did he render? To whom?

MR. TOM: He's the head of this company.

MR. McALISTER: I know but..

MR. TOM: It's a sixty million dollar company and he --

MR. McALISTER: So what's -- services to which company?

MR. TOM: To the Foundation Health Plan.

MR. McALISTER: Well, thats --

MR. TOM: He was the chief executive officer of Foundation Health Plan.

MR. McALISTER: I know, but that's -- that was a charitable corporation. He's not entitled to anything for that, other than his salary.

MR. TOM: I beg your pardon, I beg your pardon. We're talking about a period in time, a point in time six months after the conversion. Six months after the conversion when we had a for-profit organization going on. A sixty million dollar a year operation headed by him and other managers, --

MR. McALISTER: -- and he's entitled to six --

MR. TOM: -- a Board of Directors, which was controlled by the charity at that time, because it was -- the principle shareholder at that time, voted to compensate the management of the company with approximately one half of a million dollars worth of stock for services rendered. That's what the records of Foundation indicate.

MR. ROBINSON: That's in September of --

MR. TOM: September of 1984.

MR. ROBINSON: Then why on the S1 filing of March 26, 1984 do you have the same amount of money in there? I mean the same amount of stock. Which is in essence a half a million dollars at that -- I mean at the time they went public. I mean, what services were rendered then?

MR. TOM: I -- I'm -- sorry, I --

MR. ROBINSON: I mean, I'm looking at the S1 that Mr. Connelly gave me, he had to leave to catch a telephone call, but if you look on page 37 of this rather thick S1 filing --

MR. TOM: That's was not -- that is not an historical statement, I don't think --

MR. ROBINSON: No, but it's dated March 26, 1984, you're saying all these services were rendered in September '84, what I'm saying and what I'm trying to understand is why did they envision this ripoff on March 26, 1984 and then go public with the Federal government. I mean why wasn't it reflected in your documentation. Do you see what I'm saying? That six months -- they already knew six months before the services were rendered. They say here for services rendered, and that's dated March 26, 1984. You can't have it both ways.

MR. TOM: I'd like to defer responding to that question until I take a look at it. My associate is getting a copy of that.

MR. McALISTER: Since when does the law allow you to issue stock for some services that were rendered in the past?

MR. TOM: It was always so provided.

MR. McALISTER: Where's the consideration?

MR. TOM: As a matter of fact, as mat --

MR. ROBINSON: It's a different entity.

MR. McALISTER: Oh, for a different entity --

MR. TOM: The law provides -- the law provides -- this is the general corporation law provides that shares may be issued for cash, property, or services rendered. What you cannot issue them for is for --

MR. ROBINSON: Rendered to that corporate entity.

MR. TOM: Yes, that's correct.

MR. ROBINSON: That's what the chairman's going -- these services were rendered to another corporate entity, a non-profit corporate entity is what you are saying.

MR. TOM: Well, what I can tell you is what the Foundation's minutes and records as far as I know state which is that these shares were issued to the management of Foundation Health Plan for services rendered. The word is in the past tense. The compensation is for services rendered to the corporate entity that made the stock issuance, not the charity. The charity didn't pay anything. It approved the transaction, but it didn't pay anything, or issue any stock.

MR. ROBINSON: Mr. Chairman, may I --

MR. McALISTER: Mr. Robinson.

MR. ROBINSON: This is the S1 filing of the Americare Health Corporation.

MR. TOM: Can you cite me to a page so we can be looking at the same disclosure?

MR. ROBINSON: It's the S1 filing dated by the SEC March 26, 1984.

MR. TOM: I'm sorry we don't have that.

MR. ROBINSON: And, on page 37, bonus program, company has adopted a one-time only bonus program which is an aggregate of 50,000 shares of strictly common -- etc, etc, etc.

MR. TOM: Yes.

MR. ROBINSON: All right, that --

MR. TOM: That's a statement, a prospective statement. That's like setting up a stock option plan. You set it up, reserve the shares --

MR. ROBINSON: This was dated -- this was dated -- March. Your testimony, and the other testimony was that -- that was for six months services rendered -- uh, to Americare Health Corporation. What I want to know -- I'll try to do it logically. What date did Americare Health Corporation become in fact a legal entity?

MR. TOM: February 1984.

MR. ROBINSON: Okay. February 1984. I have a document in front of me dated March 26, 1984. One month. One month where they have already for services rendered during the one month period. Because I mean -- it says, one time only for services rendered, the same testimony you had, except we're back now at a one-month time frame -- how does anybody justify $600,000.00.

MR. TOM: May I see that?

MR. ROBINSON: Yeah, as soon as the chairman sees it. See look at this date, see where they become a corporation? In

March they go to the SEC, and then the company -- is this the same one -- no, no that's a footnote, that's a footnote. Here this is the bonus shares, I'm only talking about the bonus shares. Sergeant. Ignore my hen-scratching on it please.

MR. TOM: Thank you.

MR. ROBINSON: I'm only talking about the bonus shares.

MR. TOM: Uh -- All right. The statement is in the future tense.

It says --

MR. ROBINSON: Rendered is not a future tense. Rendered is a past tense.

MR. TOM: The verb in the sentence is "will be --

MR. ROBINSON: I didn't get the greatest English grades in the world --

MR. TOM: -- "will be issued" Mr. Robinson --

MR. ROBINSON: "For services rendered".

MR. TOM: Right, because you don't issue them until the services are rendered. They adopted a plan to issue them in the future for services rendered at the time of issuance. They adopted the plan in March in order to reserve the shares for issuance in the future, in September, after the services were apparently rendered, the shares were issued. I don't see anything inconsistent, I admit that it -- it's -- until I saw it, I didn't understand, and it sounded like an inconsistency to me, but now that I've read it, I don't think it's inconsistent at all Mr. Robinson. It's like a stock option plan where you organize the plan on day one, but you don't actually issue the options until some date in the future. That's all this was.

MR. McALISTER: Well, this isn't even an option. This was a -- how they call --

MR. ROBINSON: Sergeant, could you return my document to me?

MR. TOM: Yes, that's right. But it was not issued. I mean the point to be made is that there was not an issuance of stock a month after the conversion.

MR. ROBINSON: Mr. Tom, you're part of the --

MR. McALISTER: Wait a minute, let's not argue over semantics, I mean, if you were George Deubel, would it matter to you whether it was issued then, or you knew it was going to come six months later?

MR. ROBINSON: Right.

MR. TOM: I, I --

MR. ROBINSON: And you testified yourself it was because he had this fantastic -- he was the managing director who put together this fantastic operation and he had it coming to him, but that was from a non-profit -- which is a charity, and he's taking it out -- taking it out -- you know --

MR. JOHNSON: Mr. Robinson, I'm not sure that's what the commissioner said, I understood him to say --

MR. ROBINSON: That's what this document looks like.

MR. JOHNSON: -- that in September and for a period from February of 1984, services rendered from February of 1984 through September of 1984, and that a block of shares earmarked for that purpose --

MR. ROBINSON: Now what --

MR. JOHNSON: -- was set aside in March.

MR. TOM: That's correct.

MR. JOHNSON: And I assume that if the services had, in fact, not been provided during that period of time from February to September, that notwithstanding the fact the block of shares had been set aside for that purpose in March, that the transfer would not have been completed because --

MR. ROBINSON: Mr. Johnson, that's all well and good if it's an arm's length transaction, and you're a good lawyer, and I'm not one, but this was not, by anybody's testimony, an arm's length transaction. Who was the determiner of whether or not the services were rendered? The same beneficiary of the stock. That is what bothers me. Whose --

MR. JOHNSON: My understanding of the -- and I'm, truly, I'm not wanting to be argumentative about this at all, but my understanding of the time frame as it was laid out to us this morning is that Sierra Foundation was in control during that period of time. They had 100 percent of the shares of, of the Foundation.

MR. TOM: That's right. They were the only voting shareholders of the company. They --

MR. ROBINSON: And who had control of the holding company?

MR. TOM: The members of the Board of Directors who were --

MR. ROBINSON: Who had control of the holding company?

MR. TOM: -- the people who were charged with the responsibility to have approved its issuance in September.

MR. ROBINSON: Mr. Tom, who had control of the holding company?

MR. TOM: I'm sorry, I --

MR. ROBINSON: Who had control of the holding company?

MR. TOM: Sierra Foundation for Health, which owned 100 percent --

MR. ROBINSON: They elected the members of the Board and a chief executive officer of the holding company?

MR. TOM: Well, they would have elected the directors who then would have elected the officers, would be the way it would be handled.

MR. ROBINSON: Well, that's what I meant -- I mean, is that a fact?

MR. TOM: Yes.

MR. ROBINSON: Who appointed a Board of Directors of the charity?

MR. TOM: They were approved by us.

MR. ROBINSON: Who appointed the Board of Directors of the Charity?

MR. TOM: It would have been in the charter, because in a new foundation, or in a new non-profit corporation, my recollection of the law is that the original directors are elected by -- not elected, are named in the um, in the Articles of Incorporation. Probably Mr. Schwartz could answer this better than me, but I believe that would be the case.

MR. ROBINSON: In this case, in the instant case, who named it?

MR. TOM: Who named it? Um --

MR. ROBINSON: You told us this morning that you wouldn't be involved in this if it were not for the fact that it was an arm's length transaction, and I would suggest to you until proven otherwise, and I am more than willing, and I have an open mind, that the charity was, in fact, created and controlled at the outset, not necessarily now, by the -- the perpetrators of the scheme to change from a charity, or a non-profit, to a profit. They went out and created a -- and I would suggest that the person that made those appointments or did the recruitment, whether name does or does not appear on the papers, had some beneficial influence on the stockholders during the short period of time when they had control, as you say, technical, legal control of the profit corporation.

MR. TOM: The uh, the --

MR. ROBINSON: That's what I'm operating on, convince me otherwise.

MR. TOM: Well the foundation was organized under the requirement that its Board of Directors include a majority of the Board, it's a seven-man board, the majority of the board had to be community persons who were not affiliated directly or indirectly with the charity. I'm sorry, with the management of the health plan.

MR. ROBINSON: With the management.

MR. TOM: And the selection of the company, of the -- the selection of the charity's board, those four unrelated directors, independent directors, came from nominations by the Sacramento County Board of Supervisors, the retired senior volunteer program. The Sac Sierra Hospital Association, the presiding judge of the superior court of Sacramento County. United Way of Sacramento, the Interfaith Council of Churches, the Sacramento Metropolitan Chamber of Commerce, and the Sacramento Area Commerce and Trade Organization. The names were mutually agreed upon --

MR. ROBINSON: So they -- those -- the nominations were made and those entities control their own nominations, do they not?

MR. TOM: I presume so.

MR. ROBINSON: And so they --

MR. TOM: The four independent people were selected from that number.

MR. ROBINSON: And then they select four?

MR. TOM: Yes.

MR. ROBINSON: Then, they found that they all of a sudden gonna be controlling a new charity that's going to have $10 million or so, how much time did they have before the dilution? None of them had any role in the deal for 30 percent dilution of the stock. How much bene -- how much control, how much legal advice, how much other independent counsel do they have before the -- one, the stock was diluted, two before the two for one split after the dilution of stock. That's what I want to know. What did they have?

MR. TOM: You, you would have --

MR. ROBINSON: Did, did they all have all kinds of other jobs and opportunity and they just came in there and they had it de facto presented to them?

MR. TOM: I, I don't know for a fact Mr. Robinson. I presume they acted just as directors of for-profit organizations act being a director of the corporation is not normally the principle occupation of those people, they exercise their fiduciary duty as directors on a part-time basis, not on a full-time basis, and in an organization with one million dollars of cash and several million dollars of unmarketable securities, that would seem to me to be an adequate amount of time devoted by directors. But for more detailed information, you would either have to ask --

MR. ROBINSON: No, what I'm saying is --

MR. TOM: -- the charity --

MR. ROBINSON: You don't have an informed owners of the stock. They are operating in a short period of time making informed decisions. And exercising the protection -- their fiduciary responsibilities as to the charity. I mean they are going to spend during this short period of time learning what the charity is all about, what they are going to do with it. I mean they have not -- so -- I mean they are not in there protecting their own hide when the stock is being diluted, or when the split takes place, or when the bonuses are given away, or what have you. And not only that they own all the stock in a Delaware corporation, not a California corporation.

MR. LANCASTER: Mr. Chairman.

MR. McALISTER: Yes, Earl.

MR. LANCASTER: In trying to pursue this a little bit further. I don't have the full document, Dick, so if you do, it's just fine. And I'll not quote what I don't have. I'm just asking a question. This is the document I presume that's put together when they make application to the Securities and Exchange Commission, is that correct? Am I correct?

MR. TOM: Yes, that's the S1 that was referred to by Mr. Robinson --

MR. LANCASTER: Okay that --

MR. TOM: -- and anticipates --

MR. LANCASTER: -- we have the front three or four pages --

MR. TOM: -- a public offering. Actually that public offering did not occur for over a year after the date of that document.

MR. LANCASTER: Well, isn't this required, either by law or by practice, that what they are going to do in the future, and I take it this was a future circumstance, where they were going to do something in the future by giving away this bonus stock, is that correct? This -- this is required before they go public, I presume.

MR. TOM: They were required to disclose all material information, which includes all management incentive programs --

MR. LANCASTER: And this is a management program, now, whether they were right in doing it late or not, I'm not -- I'm just trying to identify this document. I'm just trying to identify the document. So this means this was a part of what was available to the public when they bought this stock, once it went public. Is that correct? Am I incorrect in that?

MR. TOM: Yes. And it's, you know, it's like writing a newspaper several weeks before the date of the event. To what extent it reflects in the past tense something that was truly past as of the date of that preliminary which is not a publicly circulated document, or whether it was anticipation of the, you know, of that occurring by the time it became a public document, I don't know.

MR. LANCASTER: So the document we're talking about was something that was required either by law or by practice. I presume by law. But you must --

MR. TOM: Yes, federal law.

MR. LANCASTER: But you must indicate what your program or plans will be as far as distribution of the stock, if you, in fact, buy a share.

MR. TOM: That's correct.

MR. LANCASTER: Thank you.

MR. ROBINSON: And I've never disputed that -- the reason I'm pointing out the times, Mr. Lancaster, and I think it's important, and it shows the state of mind that they envisioned at the time, one not only going public, fine, not only going public. That's one aspect of it. But the owners, the new -- the new management who was the old management were going to take care of themselves in the first six months. And that was envisioned at the time. It's the state of mind -- I think it indicates, and I'm not disputing this, it was required by the Federal Securities Law, 1933.

MR. TOM: Mr. Chairman, I'd like an opportunity to make an additional remark on this subject. Um, and that is that the um, from the date, from February of 1984 when this charity was created, it was -- it became a charitable organization, I don't dispute at least the possibility that the directors may not have been exercising the fiduciary duty that they had to select out --

MR. ROBINSON: I don't think they had time. I'm not attacking the directors --

MR. TOM: I just don't -- I don't know the answer to that question. I think if the committee is interested in that, that they should secure the testimony of, you know, of representatives of the Foundation. Or of -- you know of Sierra Foundation for Health. Um, the uh, Mr. Schwartz indicated that the Attorney General was reviewing the Foundation, I assume one of the reasons they are reviewing it is to determine the very question -- you know, the answer to the very question that you are raising, Mr. Robinson, and that is whether the directors with fiduciary duty exercised their duty properly, and that's where that responsibility from a government standpoint rests. Because that charity --

MR. ROBINSON: Well, Mr. Tom, I'm saying they didn't have an opportunity -- I don't want the press to get it wrong, I'm not saying that they acted unreasonably, or they didn't act. I don't believe they had an appropriate amount of time. I think the gun was loaded, the cannon was loaded by the time they were selected. They had no opportunity -- the filings were, within a month were before the Securities and Exchange Commission, going kaboom, kaboom, kaboom, and it was done. The deed was done. I don't see how they could possibly have -- they wouldn't have time to even learn what -- you know, what a fantastic opportunity they were given by virtue of their appointment. So I can't, I certainly can't criticize them, I don't even know them. I don't know any of them.

MR. McALISTER: Mr. Tom, I wonder if when you approved this transaction, did you have any idea that after the conversion was made that Americare would be going into residential real estate development?

MR. TOM: No, we did not.

MR. McALISTER: Well did -- does that bother you or trouble you, or does it make any difference?

MR. TOM: Excuse me one moment --

MR. McALISTER: Page F9 of the Securities and Exchange Commission document of September 27 or September 30 filed.

MR. TOM: There had been information on this that my staff had gotten together -- oh here it is, all right. The transaction that I believe is in question is amounted to approximately three million dollars where Americare funded up to three million dollars for the acquisition and development of a residential real estate project. The advances under the agreement were secured by deeds of trust and as of June 30, 1984 and 1985, the actual amounts advanced under those agreements, because the three million was the maximum, the amounts actually advanced as of June 30, 1984 and 1985 were respectively $1,464,000 and $2,111,000. Those amounts equaled, as of those dates 4.7 and 3.3 percent of the total assets of Americare respectively. I -- so in conclusion I would just have to say number one, we were not aware at the time of conversion that, I don't believe we were anyway, that Americare was, was to later on enter into such a transaction. The transaction would have required, and I would assume did require, although I don't know for sure, the approval of its Board, it was, I presume, you know, an investment which they made of less than 5 percent of their assets. Corporations are permitted by law to invest in whatever they believe is an appropriate investment vehicle at the time. I can't speak as to whether this was appropriate or not. It obviously was different from the health business that was their principle line of business. I don't know that this, this casts any particular aspersion upon the plan or its conversion.

MR. McALISTER: Okay. Well, why don't you proceed toward whatever you'd like to address.

MR. TOM: I thought, Mr. Chairman, if I might, I'd respond to a few of the statements that were made in both the video presentation and by some of the prior speakers during the afternoon session. The Consumer's Union representative as I understand it had two main concerns. One is, the effect of a conversion on the public, and the other, whether or not the charitable purpose was getting full value. I think the latter question is the same question we have been spending about 90 percent of our time dealing with and I don't know that I can offer anything extra at this time except to say that our understanding of the law is that the charitable value has to be the fair market value at the time of conversion, that our responsibility and the Attorney General's responsibility in the days when they had jurisdiction was to determine that fair market value, that the court in the section that I quoted to you in its opinion had affirmed the accuracy of our view that the highest bid that was available was not necessarily the final determinant of what is fair market value, it could be more because of the synergistic value or anti-competitive value that such a deal might offer to a competitor, and therefore the fact that there was an offer by a competitor to purchase at a higher price than the conversion price is appropriate information for us to take into regard. Which we did, but it is not a determinant of what the fair market value is. As far as the effect on the public is concerned, a -- I think there is a basic misperception. The fact that an HMO or an HCSP is operated as a non-profit corporation doesn't mean it doesn't make money. It doesn't mean that it doesn't make every bit as much money as it would were it operated as a profit corporation. FHP is earning and did earn at the time it was a non-profit corporation earning at the rate of approximately $40,000.00 a day. And, uh, there are successful profitable, non-profit HCSP's just as there are successful for-profit HCSP's. The mere fact that you convert from a non-profit to for-profit status, may or may not have any bearing on what the price is that you charge your subscribers. The price you charge your subscribers in a competitive situation as we have here in California is determined by competitive forces. What everybody else is charging, what Kaiser is charging, what the insurance companies are charging, what SIGNA is charging, what Maxicare is charging, as a matter of fact, for comparable services. People make their choices on those bases. If, in fact, the conversion caused the, the uh, the price of FHP's or Foundation's services to increase to subscribers, then presumably they would suffer a competitive effect. You or I, if we were subscribers there, having made the determination to go with Foundation, or FHP, might switch to another plan, simply because it was pricing itself out of the market. That's the mechanism that we rely on, and that the law relies on for determining what's the best deal. Each person makes that judgment, and each person in the market, whether he's a non-profit or for-profit entity has to compete for your dollars and my dollars and the employer's dollars. So, to me the problem is the fallacy of the underlying premise that just because you go from non-profit to for-profit status that there is an effect on the um, on the um, the subscriber price. Certainly the cost of health care has increased. We all know that, but I don't know very many people who say that the reason why health care has increased in all these various organizations that provide that care is because of conversions.

MR. McALISTER: Well, do you believe that health care, is lower or no higher after the Sacramento organizations conversion than they would have been had they not converted?

MR. TOM: I don't know, I just don't think there's a correlation between the fact that it converted and didn't convert, and what happens to the price of services. I don't think Foundation, or anyone else has that kind of market share, and monopolistic share to be able to command whatever price it feels it wants just because it wants to make more money.

MR. ROBINSON: Mr. Chairman.

MR. McALISTER: Mr. Robinson.

MR. ROBINSON: I'm looking at the prospectus. First question is why, or did your office have any communication with the company or with the company's counsel as to their initial S1 offering which had contained a valuation which was something in excess of approximately 100 percent greater than what you had accepted as a valuation? In other words what I'm asking is why did not -- the $19 million is not in this prospectus, but it was in the initial S1 filing. Why is that?

MR. TOM: Well, well if the question is --

MR. ROBINSON: And did your office have any communication with the proponents of this deal regarding the inconsistency between their S1 filing and their filing with your off -- your determination of value?

MR. TOM: Mr. Robinson, at the time of the conversion and the papers that were filed with the conversion, I don't believe we knew about, nor were we provided copies of the Bank of America appraisal, if there was one at that time. The copy of -- in fact it's a draft copy of that appraisal, that I have is actually dated August of 1984. Now that was five months after the conversion and many more months than that after they filed their application for conversion. So I'm not even sure that there was a Bank of America appraisal for $19 million or whatever the number was.

MR. ROBINSON: Well you testified that it was Price Waterhouse.

MR. TOM: In any event, we didn't have it. We didn't find out about it until quite some time later.

MR. ROBINSON: You testified in February 1984 there was a Price Waterhouse evalaution.

MR. TOM: Yes, that's what we relied on.

MR. ROBINSON: And you went through that and came up with --

MR. TOM: Ten six.

MR. ROBINSON: -- ten million, then or -- ten -- then you said -- then I came up with an S1 filing the same month that shows 19 million. And you told me they were both Price Waterhouse. Now it appears from some of these documents, and I'm having a tremendous amount of difficulty digesting it, that the B of A intervened at some point with another one that came closer to what Price Waterhouse than what was in the S1. What I'm asking you is did your office -- you made a determination that the value was approximately 10.5 or whatnot, and I'll have to find my notes, within a month there was a piece of paper filed in Washington, D.C. that says it was $19 million, and what I want to know is whether or not your staff picked up that S1 filing, and if they did what did what did they do to try to correct the, or reconcile the differences between the two valuations.

MR. McALISTER: They did find it, and they asked them for information on it. And I don't think --

MR. ROBINSON: I know that, but I'm trying to get Mr. Tom to tell me that, and then tell me how they came about that.

MR. TOM: The ah, the securities --

MR. ROBINSON: Because what happened is that in the actual prospectus they end up deleting all reference to it.

MR. McALISTER: Yes. We noticed that.

MR. TOM: The ah, a copy of the preliminary prospectus was filed with our securities division, which clears those kinds of public offerings of stock, and at that time, and I'm not sure exactly what point in time we're talking about, may have been that March draft that Mr. Robinson has, it may have been a subsequent draft, I'm not sure, but in any event we did receive that, and as a result we inquired of the company about that $19 million. Now you point out that as a matter of fact it was removed from the prospectus, but obviously it was in the preliminary and did raise a question in our minds which we pursued with the company.

MR. ROBINSON: Yeah, but what the company did, though, Mr. Tom, and that's what I want you to explain to me -- what the company did, then is to hide from the individuals that buy stock, but trade it on the exchanges, the fact that there was a value, a spread of around 100 percent between what the State said it was worth, and what the independent accounting firm said it was worth -- so that only the insiders had the benefit of that knowledge.

MR. TOM: Well, the -- the information that there, there was apparently an appraisal, or somebody's opinion that at the time of conversion the organization was worth $19 million, was not a particularly relevant fact for the public -- members of the public that were buying the stock at $10.50 --

MR. ROBINSON: It was relevant to the public then as it should have been relevant to you and your department.

MR. TOM: It was rele -- I agree it was relevant to us in our capacity as regulators of health maintenance organizations. Whether it was necessary or not to make that disclosure to the public when they were buying the stock at a price which was probably somewhere like $50 million capitalization for this company, I don't think it was particularly relevant what it was worth at the time of conversion.

MR. ROBINSON: Okay, at any time did your office or your staff inquire at the time of the initial application for conversion, did you inquire as to what appraisals were -- were out there, that the company had done? And if not, why not.

MR. TOM: We had the appraisal. We understood --

MR. ROBINSON: Did you inquire, request as part of the filing of the application for conversion with your office, did you routinely ask the applicant for all appraisals within the custody of the applicant.

MR. TOM: No Mr. Robinson, we did not.

MR. ROBINSON: And why not, then? You didn't do it independently, so I don't understand why not. All right -- I'm not going to browbeat -- that's another point for future -- I also would like to -- and I guess I have your copy of the prospectus, so I'll read it for the -- under "Legal Matters" of the prospectus, are you aw -- "Stockman Law Corporation of Sacramento has counseled the company and the selling shareholder." That is an inherent conflict of interest. Your testimony is that you have the selling shareholder, for members of the committee, is a charity. They've got the same lawyer. Now who is protected -- you can't protect both interests.

MR. TOM: The interests of the char --

MR. ROBINSON: One, that's illegal right now, I mean we've -- I've changed the law, this year, you -- counsel ended up, and they also ended up getting the same bond counsel too, is absolutely illegal. It's unethical, I'm informed by the State Bar since 1935, for a law firm to do something like that. And why the State didn't pick that up. It says right here. You don't think that's a conflict? You're a lawyer aren't you, Mr. Tom?

MR. TOM: Yes, I am.

MR. ROBINSON: Is it a confict of interest to represent the company and the stockholders of the charity simultaneously, in this type of conversion.

MR. TOM: I don't know. However --

MR. ROBINSON: Would it raise ethical questions for you as a private practitioner?

MR. TOM: Was it in the, excuse me, was it in the conver -- I..you didn't finish the sentence --

MR. ROBINSON: Stockman Law Corporation of Sacramento, California, as counsel for the company and the selling shareholder has rendered an opinion on the common stock being sold by the selling shareholder and is duly authorized, validly issued, fully paid for, and non-accessible, etc., etc.

MR. TOM: I don't understand what the conflict is.

Because there is no adverse interest between the selling shareholder and the company. They both want to sell at the highest possible price, which turned out to be $10.25 a share.

MR. ROBINSON: As far as the market is concerned.

MR. TOM: Yes.

MR. ROBINSON: But as far as these other shares that I just read to you, that's not the same.

MR. TOM: That is not what the sentence says. It doesn't say that Mr. Stockdale, or Stockman, or whatever his name was, was representing both parties in connection with transactions involving both parties as adverse parties.

MR. ROBINSON: Is counsel for the company and selling stockholder.

MR. TOM: Keep reading.

MR. ROBINSON: Well, the rest of it is the normal boilerplate language. You know, that if it finds that they're not accessible..

MR. TOM: Yeah, it says they represented both of those parties in connection with rendering an opinion under this public offering that the shares were duly and validly issued. That's a standard legal opinion that goes out --

MR. ROBINSON: Who was counsel -- all right then, in your notes, who was counsel for the charity at the time this thing was before you?

MR. TOM: I'll have to get you that information, I don't have it here.

MR. McALISTER: It was Stockman.

MR. ROBINSON: Yes, I know it was.

MR. TOM: Then, then -- I don't know.

MR. ROBINSON: I don't ask questions that I don't know the answers to, Mr. Tom. Here, you can have your file back.

MR. TOM: Were you a lawyer, you'd be a very good one.

MR. ROBINSON: I'm not.

MR. McALISTER: All right, you may proceed Mr. Tom.

MR. TOM: Thank you. I was speaking about the Consumer's Union testimony and my views with respect to the, uh, assessment of the public effect of a conversion, the other point that was made as I understand it, was on value, and I believe we have responded to that already too. Then there was the video presentation. Um, if you will recall to my testimony at the end of the morning session regarding the facts of the foundation conversion, I think that it should be apparent that there were significant differences between the statements made in the video presentation and the facts as I relayed them. The foundation -- in the foundation conversion, the charity did not receive $10.6 million. That was the amount determined for the minimum guaranteed price of the shares that they received. The value of the consideration that was received by the charity is the value of ca -- or is the amount of the cash that they have realized to date, which happens to be about $10.6 million. But, also the value of the additional $5 million or some such number of shares that they continue to hold. Whether you assign a value of $9.00

a share to each of those shares, which is their current value, or some other value to them, it's a considerable value nevertheless, and that is what the charity ended up with in that conversion.

MR. ROBINSON: And I never -- I didn't suggest, Mr. Chairman, that that wasn't the case, but what I'm obviously saying is that they ended up with 70 percent instead of 100 percent.

MR. TOM: Yes, that's correct, but the other 30 percent, with the possible exception of the 55,000 shares which were, which were -- which you pointed out were -- given for services rendered and therefore no actual hard value, you know, dollar cash value was ever paid for them, unlike the stock option shares and the stock purchase shares, and the public offering shares where hard dollars are required to be paid, um, uh, that in all of the other transactions, um, it seems to me the only question uh that there is is the accuracy of the appraisals that supported the determination of what was then the fair market value, as Mr. Schwartz suggested.

MR. ROBINSON: So, but -- I mean, so the charity has got 70 percent, I'm not disputing that, it's the 30 percent, when my understanding of the law is the charity is to get 100 percent, at least that's my understanding of the initial testimony on this particular aspect of the hearing. Was that the charity was getting 100 percent, they didn't, they got 70 percent.

MR. TOM: The 70 percent that they have is -- or got, as you put it, is 70 percent of the Americare Organization.

That's what they ended up with, some year later, or whatever the time frame is, that's correct. But the 30, that, the other 30 percent was paid for by other people, including members of the public at $11.00 a share. Now, if -- I don't really understand why, if you agree, if you were to agree that the shares were sold for a fair price, what is wrong with a foundation ending up owning 70 percent of the company, of a company, that now has far more cash to grow with because they've sold 30 percent of the company to other people at a fair price. I really don't see what's wrong with that. As a matter of fact, at the beginning of my testimony I indicated that one of the principle purposes of these conversions is capital raising. Equity capital raising is part of capital raising. If there is no ability to dilute Sierra Foundation's interests in terms of selling shares to the public, or anyone else at a fair value, then one of the key benefits of converting no longer exists.

MR. ROBINSON: Over time I would not argue with you, as there is other value, uh both uh tangible and intangible applied to the new corporation. The successor corporation. But a -- in this case this was very instant windfall to the non-charity, which was not envisioned by this legislature at the time this law was changed. I was here. I mean, it was envisioned if you're going to shift -- I mean, and then the growth -- under the capitalist system, which I cer -- totally support, with Mr. Johnson, would come from the tangible and intangible gains made by the free enterprise management. But at the time this deal went down, the charity got 70 percent instead of 100 percent, which was what was envisioned.

MR. TOM: I, I'd like to, to uh --

MR. ROBINSON: And it appears a similar situation in the other -- in the Long Beach case --

MR. TOM: I'd like to go back to the testimony of Ms. Tanner when she was talking about the judgmental quality that goes into determining what kind of a valuation method you use when you evaluate a company, because there are so many different ways of approaching that issue. She stated that one of the determinants is wheth -- is, is, is..is what, what are you looking at, a market value or a transfer value. Are you looking at the value of a hundred or a few hundred shares that buyers and sellers on the New York Stock Exchange would be willing to pay for a few hundred shares, or are you looking at the transfer value, the value in bulk of the entire enterprise. And as I recall her testimony, it was when you're talking about market value, New York Stock Exchange type value, then price earnings multiples type determinations are a fair way of proceeding for determining fair market value. When you're talking about transfer value, then you look at things like discounted cash flow, and um, and -- and similar methods, which yielded in this case very close to the same values that we actually ended up with. Um, the -- the use of the multiples of 70 times earnings and so forth that people are willing to pay for a few shares is not necessarily the proper way of determining fair market value in these conversions. That is why we have chosen not to use them in some cases.

MR. ROBINSON: When is it appropriate to ask questions of Mr. Tom on the other FHP in Southern California?

MR. McALISTER: Sure.

MR. ROBINSON: All right. Okay. At my request you have kindly supplied me with a copy of the note on that transaction. I notice that it's a subordinated uh non, uh, non-negotiable note. I had my staff -- what date was this note signed, please?

MR. TOM: It would have been as of the conversion date, Mr. Robinson.

MR. ROBINSON: It says November of 1985, but I don't have a date.

MR. TOM: It would have been the date of conversion, which was like the 27th or 28th.

MR. ROBINSON: Okay. And say 10 percent per annum, and what's the size of the -- what's this note size?

MR. TOM: It looks like $28 million.

MR. ROBINSON: 28 million dollars. All right. Looking at today's Wall Street Journal, on subordinated debentures, AT&T, which is a Triple A, good credit, uh, approp -- approximates the right interest, 10.38, 3/8, went out at 101, which is pretty close to par value. So AT&T is paying a little more than 10 percent, uh, for -- in a very secure, negotiable security, probably not callable --

MR. TOM: What is the maturity of those securities? I'm not familiar with the issue.

MR. ROBINSON: No, I just picked the sheet -- All I'm saying --

MR. TOM: The maturity value is very important, thirty --

MR. ROBINSON: No, I'm --

MR. TOM: -- (unintelligible) carries a much higher, higher uh --

MR. ROBINSON: I'm picking one that's going at around par, that's a good security we all generally would accept as gene -- this is not an empirical analysis. What I am saying is that this paper is not near as worth anything like AT&T, and the charity in my mind got treated considerably at 10 percent interest, given this current market.

MR. TOM: Uh huh.

MR. ROBINSON: And I -- if -- what I guess -- what I'm leading up to is the question, is when you valued what the charity was getting, did -- did you value this at face value, $38 million, when in fact the time value of it is kind of like the way we run this lottery -- we say we're giving people $2 million, baloney, we're giving them $80,000.00, and what this is is a big lotto for the benefit of the new corporation and to the detriment of the charity. And I want to know whether or not those questions were raised by your staff, and if so would you explain where I'm wrong? And I'm cer -- I'm a very humble man, I'm more than willing to accept it.

MR. McALISTER: Explain where he's wrong, Mr. Tom.

MR. ROBINSON: Because if not, I would like you to loan me --

MR. TOM: How much time do I have?

MR. ROBINSON: -- $38 million and I will pay you 10 percent.

MR. TOM: Mr. Johnson might take you up on it, Mr. Robinson.

MR. JOHNSON: You pay me $28 million -- (Unintelligible)

MR. TOM: The matter of the interest rate, just as the matter of the terms of payment, how much goes in cash, and how much is deferred and how it's deferred for how long, how it's secured, are all negotiated elements, along with the price. Uh, and that would have been one of the negotiated elements. In the past, um, and this includes a period of time when the uh, when we had the benefit of the input of the Attorney General, we used interest rates um, of between, usually about between 10 percent and 12 percent. Um, in the Internal Revenue Service regulations relating to imputed interest, um 10 percent is used. Um, so, um while one, while one can, can uh, uh, debate the question of what is the ah what the interest rate would be if one were going out in a public offering of this security, um ah --

MR. ROBINSON: How about just discounting at your local bank? You don't have to go to a public offering. I..if you go to discount, if it was allowed, which it's not allowed, which makes it even fur...more suspect. I mean, the imputing of interest is common practice. And if you want to talk about what the Attorney General's regs are pursuant to the usury provision in the constitution, that's one thing, and I would suggest to you a better parallel would be the...uh, either the Federal Reserve Rate, plus 5, which is used in other federal indices, or whether you want to use the...what we did, Mr. McAlister, with the tax structure both ways, is the prime rate plus 2, isn't it? Isn't that the maximum we charge for late payments, and...that's what we pay back to the taxpayer when we're late paying them back. Uh...something like that. There's all kinds of other indices that are used by the federal government, that are similar to what the private sector uses, rather than that usurous limitation of 10 percent or 12 percent.

MR. TOM: I'm sorry, I think I misled you, I did not mean the Attorney General's...the California Attorney General's rules on usury, but the IRS's rule on imputed interest for tax purposes, you know, where you have notes and business transactions, and this is necessary to impute interest.

MR. ROBINSON: Yeah, but this is non tax exempt. This isn't a tax...the treasury...the ordinary treasury regs don't apply to this. This note. They might apply to whatever...they probably, that's the other question, is what the debt...listing tax exempt debt, but what...was this valued at face value in terms of your approval? That's my final question on this aspect of this transaction. Was it valued at $38 million?

MR. TOM: We did not, we did not impute another interest rate to discount the value of the balance of the notes, so I guess the answer is we did not.

MR. McALISTER: Mr. Elder.

MR. ELDER: Well, on interest rates, I just arranged to borrow $13,000.00 at 11 percent interest simple, and no payments for eighteen months, so you know, in terms of...I don't know what that...how you discount that out, but I thought it was a pretty good loan.

MR. TOM: I do too.

MR. ELDER: So, you know, I mean, the market out there, and this was negotiated about, almost on the same day, about the 25th of November, and so I won't have to make any payments on that money until July 1 of 1987. So, it's kind of a, the interest world out there right now is not...you know, there is not a monolithic interest structure...

MR. ROBINSON: But you can refinance that too, Mr. Elder, and they can't refinance this $38 million.

MR. ELDER: Well, I know. I know the trustees of that charity in Long Beach, and they all think that it's a marvelous deal, there is no complaint from the community, I mean, and I think the proposal offers some unique advantages to my district, uh, and I know personally three of the trustees who, uh, one of which is the president of the State College in Long Beach. He's...another is a person who is extremely supportive of the arts, I mean, I think that this is a...that 10 percent under this circumstance may, have been, in fact, a very good rate of return. I'll tell you this, if somebody wants to give me...

MR. ROBINSON: The law says that all the money has to go to the charity.

MR. ELDER: Fine.

MR. ROBINSON: I'm saying that this...

MR. ELDER: If somebody wants to give me any money...I'll make this announcement right now, uh, I'll let them pay me 5 percent interest, 6 percent interest. I'll make you a deal. I'll tell you what, 4 percent. If you want to pay 4 percent on the money you tell me you're going to give me...at some specific date in the future, we won't worry about it, and I'll even pay the imputed interest taxes to the IRS and FTB, if they're in that business. I think it's a hell of a deal.

MR. ROBINSON: The analogy doesn't hold.

MR. ELDER: Well.

MR. ROBINSON: And the law firm that drafted that is in Orange County, not in Long Beach.

MR. McALISTER: All right. Anything more Mr. Tom?

MR. TOM: I don't believe so.

MR. McALISTER: All right. Back to this one question, in October of 1983 Mr. Stockman sent Mr. Zablocky um Foundation Health Plan Application for Material Modification, and among other things he says, there's a heading here, it says, Price Waterhouse valuation - FHP has substituted its own valuation.

Now, there...was that a...did you accept that?

MR. TOM: I, I'm sorry, are we on FHP now?

MR. McALISTER: Yes, October 15, 1983. Foundation Health Plan.

MR. TOM: Would you repeat the statement that was made that you're questioning?

MR. McALISTER: Well, he says, here, FHP charitable issues. Enclosed, but note following materials earlier discussed have been substituted. Price Waterhouse valuation - FHP has substituted its own valuation.

MR. TOM: I, I don't know. I can't respond to that because I don't know what that's about.

MR. McALISTER: What...the valuation of the non-profit, no, that's the $10.6 million we're talking about.

MR. TOM: Yes, but the substitution is your question, I think, not...

MR. McALISTER: Yes. Well, it's rather terse, he says FHP has substituted its own valuation. On the second page of that letter near the top. 3.1.

MR. TOM: I, I'm sorry. I'm unable to get adequate facts to respond to you for now.

MR. McALISTER: All right. Perhaps you when you go back to your office, you might discuss this with others and submit a written...

MR. TOM: I would do that and submit a written response to you. (Aside) Would you make a note on that?

MR. McALISTER: Sure, fine. All right, thank you. Any other questions of the commissioner? All right, thank you commissioner, you've been very patient and very thoughtful, cooperative. We appreciate your help.

MR. TOM: Thank you.

Mr. McALISTER: At this point our agenda indicates that we're going to return to the Attorney General, however, it's my understanding that, and I wanted to ask if this is true, that the Attorney General doesn't need to testify any more? We've already testified at some length.

UNIDENTIFIED: We are at your pleasure. We are here, but...

MR. McALISTER: All right. All right, thank you. Let's see. We have, I guess that just about wraps it up, unless there are any unscheduled witnesses who feel that they want to put themselves on our schedule and contribute to our deliberations. I guess not. All right. Thank you, we'll...the committee appreciates everyone's participation, and we'll certainly be digging into this with some care in the future. Thank you very much.

California Legislature

Assembly Committee on Finance and Insurance

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November 26, 1985

MEMORANDUM

TO: Members, Assembly Finance and Insurance Committee
Assembly Judiciary Committee
Senate Insurance, Claims and Corporations Committee
and Interested Parties

FROM: Sal Bianco, Principal Consultant

SUBJECT: Notice of Interim Hearing and Background Information

The Assembly Finance and Insurance Committee will conduct an interim hearing on the subject of the conversion of a nonprofit public benefit corporation which is a licensee under the Knox-Keene Health Care Service Plan Act of 1975 to for-profit status. A review of the responsibilities of the Department of Corporations, Insurance, and Justice in this conversion process will be one focus of the hearing. Two specific case studies will be examined in depth. They are the proposed conversion of FHP, Inc., a Fountain Valley based health care service plan, and the already approved conversion of Foundation Health Plan which is based in Sacramento. Both Maxicare and CIGNA Health Plan are involved in the proposed FHP, Inc. conversion process. Four significant issues scheduled for examination are: the role of self-dealing agreements in the conversion process; the determination of the value of a company's good will; determination of a company's value; and, the charitable distribution plan proposed for utilization after conversion occurs.

The hearing will begin at 10:00 a.m. on December 4, 1985 in Room 447 of the State Capitol. A luncheon recess is scheduled between 12 noon and 1:00 p.m. The hearing should conclude by 4:00 p.m.

Requested to testify are the Commissioners of Insurance and Corporations with their appropriate staff and the Department of Justice. Four health plans, FHP, Inc.; Foundation Health Plan; Maxicare; and CIGNA Health Plan have been advised of the hearing and invited to attend and participate if they so desire. The hearing format is as follows: The Departments of Corporations and Justice will give a separate 10 minute maximum presentation on their role in the conversion process. A representative of one of the major accounting firms will provide testimony on valuation of companies. After these background presentations, the Insurance Department has been asked to testify on these issues as they revolve around Chapter 11A of the Insurance Code providing for jurisdiction over nonprofit hospital service plans. It appears that currently there are no statutory or regulatory provisions dealing with conversion or the valuation of these companies. The Insurance Commissioner, however, will discuss how company valuation is determined by his Department in instances of conservatorship and liouidation of insurance companies. The Corporations Commissioner and his staff will be asked to provide a lengthy presentation dealing with various policy issues and case studies. This presentation should begin in late morning and continue after the luncheon recess. We have asked the Department of Justice to make its presentation following the Corporations Commissioner's concluding remarks in the afternoon session. I have attached a copy of our invitation letter to the Corporations Department for your review prior to the hearing. The letter will provide insight into the breadth of our inquiry. I have attached enclosures for Legislative Members and staff.

There are approximately 50 to 60 licensed Knox-Keene health care service plans under the jurisdiction of the Department of Corporations. The prepaid health plan scandals of the 1970's gave rise to the development of the Knox-Keene Act, the transfer of jurisdiction over these plans from the Department of Justice to the then newly created Department of Corporations, and the requirement that medical and financial audits of the plans be conducted by the Department of Corporations. Since the creation of the Knox-Keene Act, approximately 12-20 plans have requested conversion. Approximately two plans per year are seeking approval to convert. There are approximately 30-40 plans which could seek to convert. Nonprofit hospital service plans are within the jurisdiction of the Department of Insurance. These plans are governed by Chapter 11A of the Insurance Code commencing with §11491. There are two currently licensed nonprofit hospital service plans. They are Blue Cross of California and Health Plan of America.

Section 1352 of the Knox-Keene Health Care Service Plan Act of 1975 provides for a plan to request a material modification to its operation, which includes conversion, and this procedure must be approved by the Department of Corporations. Section 9912 of the Corporations Code defines a nonprofit public benefit corporation. Corporation Code §§5813.5 and 10821 provide a process whereby the nonprofit articles of incorporation are amended to convert to a for-profit business corporation. Self-dealing transactions are discussed in Corporations Code §5233. A self-dealing transaction is any transaction to which a corporation is a party in which one or more director has a material financial interest. The Administrative Code provides a process whereby the Corporations Commissioner is permitted to approve a self-dealing transaction if the Commissioner determines that standards have been met, the proposal is consistent with trust purposes, and the directors have not acted negligently or fraudulently.

The Department of Corporations has primary jurisdiction over the administration of the general nonprofit corporation law. The Department is charged with: 1) supervision of assets held by charitable trusts; and 2) prevention of any asset used in a manner inconsistent with charitable trust purposes. Department of Justice has residual authority to oversee and protect nonprofit corporations with assets held in charitable trust.

Under common law, charitable corporation directors are required to obtain the best price possible for the sale or conversion of assets. Also see Corporations Code §5001, et. seq. The Attorney General under common law jurisdiction, Uniform Supervision of Trustees Charitable Act (Government Code §12580, et. seq.), and the California Corporations Code, appears to have enforcement jurisdiction. The Department of Corporations appears to have a clear duty to protect and preserve the charitable assets of the corporation.

Regarding self-dealing transactions the Department of Justice appears to have authority to act. I have attached a Department of Justice September 26, 1985 letter in this regard. In the case study of FHP, Inc.'s proposal to convert, there is an existing April 15, 1977 agreement between a number of the parties involved in the conversion process and the Attorney General's Office which prohibits self-dealing without approval by the Attorney General. This agreement has been in the possession of the Department of Corporations since 1978. I have enclosed other documents for your review on the self-dealing transaction and the proposed conversion of FHP, Inc. issues: Department of Justice letters of October 23 and November 5 discussing valuation and self-dealing transaction validity; Los Angeles Times news articles of October 3 and 19 providing a cursory view of these issues; and, an article from the Los Angeles Daily Journal of October 7 involving the Departments of Justice and Corporations. Also enclosed is a September 16, 1985 letter addressed to the Department of Corporations further explaining the key issues involved in the proposed conversion.

Unlike FHP, Inc. which is requesting conversion, Foundation Health Plan based in Sacramento received formal approval in February of 1984. In the Department of Corporations's two-hour briefing for Legislative Staff, Department indicated that this conversion is a model. I have enclosed for your information an 11-page June 5, 1984 letter to Assembly Member Lloyd Connelly which was prepared by the law firm for Foundation Health Plan at the request of the Department of Corporations. The first five pages of the letter and pages 8-11 provide some indication of the conversion process for this plan. As you will note from the invitation letter to the Department of Corporations, we have requested a number of documents which will be utilized in a close examination of this conversion.

In determining the value of a company, there appears to be three common techniques utilized. They are: discounted cash flow; liquidation value of business assets; and price earnings multiples realized by similar companies which are publicly traded. It appears that each technique will result in a different value which can be at substantial variance. On this subject, I have enclosed two documents for your review. They are a memorandum discussing fair market value versus stated book value and an article on valuation.

During the hearing, these questions will be considered. They are: How is the value of a company determined and approved by State regulators? What is the value of a company's good will? What screening criteria needs to be established to evaluate the conversion value? To what degree is the public receiving a fair price for the company which converts? Are the conversion monies distributed for charitable purposes? Are the state regulators recognizing the role and responsibility of the Department of Justice in protecting the public in these conversions? To what extent are the founders of these companies utilizing tax dollars for private profit-making purposes which were intended to provide health care? What guidelines are currently in existence to ascertain valuation? What factors led the Corporations Department to lower its value of FHP, Inc.? To what extent are the founders of these companies retaining control over the charitable trusts established after conversion? To what extent should the state be able to recoup lost tax revenue from the purchase price of the converted company? Does the Department of Corporations require a financial audit and medical survey prior to conversion to protect the financial viability of the plan and to ensure the adequate delivery of health care? Does the Department of Corporaticns believe it must maintain a rule of prohibiting anti-trust violation and encouraging competition? How are plan subscribers and providers benefited in the conversion process? To what extent should subscribers be accorded reduced health care subscription rates as an essential part of the charitable distribution plan?

This memorandum also serves as background information on the hearing from a policy committee staff perspective. There will be a number of documents for distribution and review during the hearing. They will be distributed at the hearing. Please feel free to contact me if you need any additional information.

SB:ws

14 ...

California Legislature

Assembly Committee on Finance and Insurance

ALISTER McALISTER
CHAIRMAN

STATE CAPITOL BUILDING
SACRAMENTO, CALIFORNIA
95814
(916) 445-9160

November 21, 1985

Mr. Franklin Tom, Commissioner
Department of Corporations
1107 Ninth Street, Room 800
Sacramento, CA 95814

Dear Commissioner Tom:

As you are aware, the Assembly Finance and Insurance Committee will conduct an interim hearing beginning at 10:00 a.m. on Wednesday, December 4, 1985. The hearing will be in Room 447 of the State Capitol in Sacramento. The subject of the hearing is a review of the responsibilities of the Departments of Corporations, Insurance and Justice in conversion of a public benefit corporation from nonprofit to for profit status. The specific case studies are FHP, Inc.'s of Fountain Valley; and Foundation Health Plan's (FHP) of Sacramento material modification to their plans which request conversion approval and the role and responsibilities of those state agencies involved in this procedure. Both Maxicare and CIGNA Health Plan are involved in the FHP, Inc. conversion process. We have requested verbally and by letter the Commissioner of Insurance with his appropriate staff to attend, participate and testify. This request has also been given to the Department of Justice.

We have invited the Members of the Senate Insurance, Claims and Corporations Committee chaired by Senator Alan Robbins to attend this hearing if they so desire. This procedure is in lieu of a formal Joint Hearing.

I am writing to formally request your attendance and the attendance of the following Department officials: Deputy Commissioner Richard Camilli; Mr. Warren Barnes; Mr. Dave Meadows; Mr. James W. Hopkins; Mr. Michael Zablocki; and, Ms. Gloria Richards-Johnson. There may be other Department officials which you feel should also attend. We would have specified these individuals if our request made over three weeks ago to provide us a list of key Department officials involved in the FHP, Inc. conversion process would have been provided in a timely manner. We hasten to add that our request for this list of officials is still needed, as well as our request for a chronological listing by date and parties involved in the months of September and October of 1985 in the FHP, Inc. conversion process. We understand from Mr. Barnes that the Department is processing our request and hopes to submit these materials in advance of our interim hearing.

Regarding the case studies of the conversion of Foundation Health Plan and FHP, Inc., we suggest that you bring to the hearing room in anticipation of Committee questioning and your presentation documents in Department possession both prior to and after formal approval of conversion on the following issues: reasons stated by the plans for their request to convert; requests for a material modification to convert; specified Code sections, memorandums, and regulations dealing with self-transacting agreements, conversion, conversion specifying the need for continuing plan management, coordination between your Department divisions in the conversion process (including the offering of securities and stock), and requirements for the conducting of medical surveys and financial audits; memorandums which coordinate activities of the Department of Justice, and other state agencies with your Department in the conversion process; copies of completed medical surveys and financial audits of these plans; copy of the agreement and stipulation of April 15, 1977 between the Attorney General and various individuals involved in the FHP, Inc. conversion; articles of incorporations and bylaws of the nonprofit plans both approved and proposed for profit plans, and charitable trusts; copies of the board of directors with names and public/private sector designation to the positions which they fill for the previously mentioned entities; valuations and appraisals of the plans; submitted charitable distribution plans both approved and disapproved; and, any other items which you feel pertain to the issues of self-transacting agreements, determination of a company's good will, determination of a company's valuation, and charitable distribution plans.

I want you to know that we appreciate your Department's efforts in providing a two hour briefing on the subject of conversion to our Committee Staff and the Staff of both policy and fiscal committees in both Houses, as well as the Legislative Analyst's office.

We intend to require testimony from you and your appropriate staff on our Interim Hearing subject matter. Your intimate knowledge and expertise in this significant policy area will prove of great assistance to our Committee in its deliberations.

It is this Committee's intent to engage in as comprehensive an examination of this issue as possible. In light of the seriousness of this problem, my Committee Consultant, Sal Bianco, indicated in a telephone conversation with Business, Housing and Transportation Agency Deputy Secretary Howard Gould three weeks ago our intent to conduct an interim hearing in order to provide you ample opportunity to be prepared to respond to any question the Committee intends to ask and be prepared to respond to the items which I have indicated in the previous and following paragraphs. Mr. Gould indicated to Mr. Bianco that he had informed both Commissioners of our intent to hold this hearing and our need for Commissioner and Department staff participation. As developments have warranted we have been in immediate contact with Department staff apprising them of new scopes of inquiry.

Regarding your presentation, we intend to divide it into two parts. After the Committee Chairman's opening statement, we intend to request your Department and the Department of Justice to provide separate ten minute maximum presentations on your role and responsibilities regarding conversion. I suggest that Mr. Barnes and Mr. Meadows of your staff provide this ten minute presentation. It appears that they are capable of reducing their two hour presentation to legislative staff to a ten minute presentation for Committee Members. I further suggest that they modify their two hour presentation by providing in the ten minute presentation through flip charts an indication of the conversion approval process involving Department staff and other State agencies and by chart if outside entities are utilized by your Department in the conversion process. You need to duplicate the previously mentioned charts for the case studies of the two health care service plans we have specified. These specific health plan conversion approval charts can be utilized in the second portion of your presentation. We would hope that you and your key Department staff will provide us with a presentation on the case studies we have indicated and responding to those areas I have previously mentioned. Utilization of the documents which we have requested for clarity will be useful. I suspect that your presentation will begin in the late morning portion of the hearing and continue after the luncheon recess which ends at 1:00 p.m. It appears that inquiries by Committee Members will occur in your late morning and early afternoon continuing presentations.

You and your Department officials should plan to stay for the entire hearing. Your testimony will be one of the major agenda items.

I look forward to a written confirmation of your attendance and Department staff members in the affirmative no later than November 30, 1985 on our invitation to attend, participate and testify.

We will be recording this hearing. Written testimony and materials submitted after the hearing will be accepted until December 31, 1985, and will become part of the official hearing record. As always, should you have any questions, please feel free to contact our Committee Consultant, Sal Bianco, at (916) 445-9160.

Sincerely yours,

ALISTER McALISTER

AM:ely
cc: Howard Gould, Business, Transportation, Housing Agency
Richard Camilli, Deputy Corporations Commissioner, Health Plan Regulation Division, Sacramento
Warren Barnes, Office of Policy, Sacramento
Bill Kenefick, Legislative Liaison
Dave Meadows, Division of Enforcement

JOHN K. VAN DE KAMP
Attorney General

State of California
DEPARTMENT OF JUSTICE

350 McALLISTER STREET, ROOM 60
SAN FRANCISCO 941
(415) 557-25

(415) 557-166

September 26, 1985

Rick McKnight
Attorney at Law
Jones, Day, Reavis & Pogue
One Century Plaza, Suite 3600
2029 Century Park East
Los Angeles, California 90067

RE: MaxiCare v. Gumbiner, Los Angeles Superior Court No. 565072 (Proposed Purchase of Family Health Program, Inc. by HMO Health Group, Inc.--Self-Dealing Transaction)

Dear Mr. McKnight:

It has recently come to the attention of this office that Family Health Program, Inc., a charitable corporation, has entered into a conditional contract to convert to for-profit status through the sale of its business to HMO Health Group, Inc., a corporation in which Robert Gumbiner, an officer of FHP, holds a majority interest. This transaction has apparently been entered into without notice to, or the approval of, the Attorney General.

Any such transaction, without such notice and the express written approval of the Attorney General, is absolutely forbidden by the terms of the 1977 settlement agreement in the case of People v. Gumbiner, Los Angeles Superior Court No. C190441. Provision 4 of said settlement agreement reads in relevant part as follows:

> "That no officer or director of Family Health Program, Inc., nor any corporation, partnership, or business entity of any kind in which any officer or director of Family Health Program, Inc., holds any financial interest, shall contract or have any business or financial dealings with Family Health Program, Inc., without prior notice to and express written approval of the Attorney General."

Moreover both Dr. Gumbiner and FHP, Inc. are express signatories to the 1977 settlement agreement, as are Irene Sweeney and Gunther Klaus (the FHP directors who apparently voted to accept the HMO Group, Inc. offer). For your information, I have enclosed a complete copy of the April, 1977 settlement agreement hereto.

As I'm sure you are aware, serious questions have been raised in the case of MaxiCare v. Gumbiner with respect to the fairness to the charitable corporation of the proposed offer by HMO Group, Inc. Specifically, we have been advised that the self-dealing transaction in question may represent an undervaluation of FHP, Inc. in an amount over $10 million, with the attendant loss to charity of said amount. Given the nature of these questions, and this office's past enforcement problems with FHP involving self-dealing and breaches of trust, we are extremely concerned over FHP's apparent violation of the express terms of the 1977 settlement agreement.

For these reasons, we shall be compelled to take appropriate legal action to enforce the terms of the 1977 settlement agreement and to prevent consummation of the self-dealing transaction between FHP, Inc. and HMO Group, Inc. until such time as we have had an opportunity to thoroughly evaluate the transaction and determine whether or not it should be approved by the Attorney General.

Should you desire to discuss this matter prior to the October 4, 1985 hearing, please contact Deputy Attorney General Bill Abbey at (213) 736-2007.

Very truly yours,

JOHN K. VAN DE KAMP
Attorney General

JAMES R. SCHWARTZ
Deputy Attorney General

JRS/adg
enc.

cc: Honorable John L. Cole
William Abbey
Gloria Richards-Johnson
Albert Rodriquez

AGREEMENT AND STIPULATION

THIS AGREEMENT AND STIPULATION, made as of this _____ day of ________________, 1977, by and between the People of the State of California (plaintiff) appearing through Evelle J. Younger, Attorney General of the State of California (hereafter "Attorney General") and defendants Robert Gumbiner, Gunther Klaus, William Baral, Frank Eaton, Ben Holzman, Seymour Stein, Elton Wisdom, Frank Volpe, Irene Sweeney, William Stabler; Family Health Program, Inc., a California non-profit corporation; Plaza Pharmacy Corporation, a California corporation; Plaza Land Corporation, a California corporation; Physicians Equipment Rental Co., a California corporation; Leisure Facilities, Inc., a California corporation; Santa Ana Development Associates, a limited partnership; Fountain Valley Land Development Co., a limited partnership; Development Associates, a partnership; Medical Centers Building Co., a partnership; and Fountain Valley Development Associates, a limited partnership:

RECITALS OF FACT

1. On February 18, 1977, the Attorney General filed a complaint in the Superior Court for the County of Los Angeles (complaint No. C190441) on behalf of plaintiff against the above named defendants, and various fictitiously named defendants, entitled "Complaint for Restitution, Damages, Surcharge and Removal of Trustees, Enforcement of a Charitable Trust and for Injunctive and Other Equitable Relief."

2. Plaintiff and defendants, and each of them, desire to terminate the litigation as between themselves and to otherwise dispose of the claims set forth in said complaint as hereinafter provided.

Now, therefore, in consideration of the mutual covenants contained herein, plaintiff and defendants, and each of them, stipulate and agree as follows:

1. That Family Health Program, Inc., a ~~California~~ non-profit corporation, holds assets on trust for charitable purposes and is subject to the Attorney General's supervision pursuant to California Corporations Code section 9505;

2. That Family Health Program, Inc., a California non-profit corporation, shall be subject to the Uniform Supervision of Trustees for Charitable Purposes Act (Government Code section 12580 et seq);

3. That defendants Family Health Program, Inc., Plaza Land Corporation, Plaza Pharmacy Corporation, Physicians Equipment Rental Company, Santa Ana Development Associates, Fountain Valley Land Development Co., Leisure Facilities, Inc., Development Associates, Medical Centers Building Co., and Fountain Valley Development Associates shall make available to the Attorney General, upon reasonable notice, all of their financial and business books, records, and documents;

4. That no officer or director of Family Health Program, Inc., nor any corporation, partnership, or business

entity of any kind in which any officer or director of Family Health Program, Inc., holds any financial interest, shall contract or have any business or financial dealings with Family Health Program, Inc., without prior notice to and express written approval of the Attorney General. Said provision shall not, however, preclude any individual defendant herein from receiving reasonable compensation for services rendered solely to Family Health Program, Inc., as an officer, director, or employee thereof;

5. That with respect to each of the for-profit corporations, partnerships, limited partnerships, or other business entities owned and/or controlled, in whole or in part, by officers and/or directors of Family Health Program, Inc., and doing, or having done, business with Family Health Program, Inc.; it is further agreed by the parties and stipulated in accordance therewith as follows:

A. Re: Plaza Land Corporation

(1) That the interest rate on the loan dated approximately March 1, 1974, from Family Health Program, Inc., to Plaza Land Corporation in the amount of $676,000 shall be increased, retroactive to the date of its execution, to 10 percent per annum, the maximum rate allowable by law; that all additional interest accrued as a

result of said interest rate increase shall be paid by Plaza Land Corporation to Family Health Program, Inc., within 30 days hereof.

(2) That the existing building lease between Family Health Program, Inc., and Plaza Land Corporation shall remain in effect subject to the following conditions:

(a) That the Attorney General shall be provided by defendants with valuation data on comparable building leases in order to permit determination as to whether Family Health Program, Inc., is being charged fair market value on its building lease by Plaza Land Corporation. In the event the Attorney General, in his sole discretion, deems it necessary, a qualified appraiser, acceptable to both the Attorney General and Plaza Land Corporation shall be retained at the expense of Plaza Land Corporation, to render an opinion of fair market value of the lease provisions. Said appraiser's finding shall be binding on the parties.

(b) In the event the independent appraiser finds that Family Health Program, Inc., has at any time been charged in excess of fair market

JOHN K. VAN DE KAMP
Attorney General

State of California
DEPARTMENT OF JUSTICE

350 McALLISTER STREET, ROOM 6000
SAN FRANCISCO 94102
(415) 557-2544

October 23, 1985

Warren L. Barnes
Dept. of Corporations
1107 Ninth Street, Rm. 800
Sacramento, CA 95814

Re: Maxicare v. Gumbiner
LASC No. C 565072

Dear Warren:

As I am sure you are now aware, Judge Chernow denied this office's request for a preliminary injunction in the above entitled matter on October 18, 1985 - holding, in fact, that he was inclined to the belief that a damage remedy would be sufficient under the circumstances. (I have attached a copy of the transcript of the Judge's ruling hereto for your information.

Notwithstanding the aforementioned ruling, the court specifically noted that significant questions had been raised regarding the sufficiency of the valuation of FHP's real property holdings and the valuation placed on the business' "goodwill" and that these questions had not been adequately answered in the documents submitted to court - which included both the Ernest & Winney & Higgens, Marcus appraisals (Judge Chernow's ruling, pgs. 1-2).

Moreover, Judge Chernow also found that this office has residual charitable trust jurisdiction to enforce FHP's obligations to charity under the common law and, as such, that FHP could not appropriately enter into self-dealing transactions without the regulatory approval of the Attorney General in light of the prior settlement agreement. (Chernow ruling, pg.3.)

We have been advised by Gloria Richards-Johnson of your department that a new application for conversion will be required of FHP prior to any action by the Department of Corporations. We would appreciate your advising us as to whether, in light of Judge Chernow's ruling, your department will require additional valuation information regarding FHP's real property assets and "good-will." Moreover, we would also request that you advise us as to whether you will require FHP to obtain the Attorney General's approval under the 1977 settlement agreement now that the Judge has indicated that FHP has an obligation to obtain such.

Finally, as we have previously indicated in discussions with your Department, we have serious questions regarding the proposed charitable distribution plan, which we feel is in violation of the cy pres doctrine.

We would appreciate it if you would provide us a response to these questions at your earliest convenience.

Very truly yours,

JAMES R. SCHWARTZ
Deputy Attorney General

JRS:my
Enc.

cc: Carole Kornblum
Andrea Ordin

JOHN K. VAN DE KAMP
Attorney General

State of California
DEPARTMENT OF JUSTICE

350 McALLISTER STREET, ROOM 6000
SAN FRANCISCO 94102
(415) 557-2544

November 5, 1985

Warren L. Barnes
Dept. of Corporations
1107 Ninth Street, Rm. 800
Sacramento, CA 95814

Re: Maxicare v. Gumbiner
LASC No. C 565072

Dear Warren:

The purpose of this letter is twofold. First, I felt it appropriate to advise you that this office is currently retaining an independent expert in the area of business valuation to provide us with an opinion of value re FHP Inc. As we have advised your Department, we have substantial concerns regarding both the methodology and underlying financial data upon which the Ernst & Winney appraisal was based. These concerns raise, in our minds, serious questions with respect to the reliability of that appraisal and the potential undervaluation thereof.

We will, of course, provide your Department with a copy of the report submitted by the independent expert we have retained so that you may factor this into your analysis of any future self-dealing conversion proposal which may be submitted by FHP Inc. should you so desire.

Second, in this regard, we would appreciate it if you would respond to the questions raised in my October 23, 1985 letter to you as soon as you are able to do so.

Very truly yours,

JAMES R. SCHWARTZ
Deputy Attorney General

JRS/my

cc: Carole Kornblum
Andrea Ordin, LA

Los Angeles Times

Thursday, October 3, 1985

State to Enter Legal Battle of 2 HMOs

Maxicare Bidding for FHP, Which Seeks to End Nonprofit Status

By DAVID JOHNSTON, *Times Staff Writer*

The state attorney general's office is expected to enter a legal battle between Maxicare Health Plan, a Hawthorne-based health maintenance organization, and rival FHP Inc., which wants to convert to for-profit from nonprofit status.

FHP's founder and other key employees have made a $36-million bid for the assets of the Fountain Valley-based health-care organization. But last month, Maxicare filed a lawsuit to force FHP's management to accept its $50-million cash offer. When a nonprofit organization converts to for-profit status, the buyer must repay the public for the value of its assets, usually by making contributions to other charities.

Attorneys for both HMOs said they have been notified that the charitable trust division of the attorney general's office intends to seek a temporary restraining order today in Los Angeles County Superior Court to prevent FHP's sale at the lower offer. That offer would pay $7.2 million in cash, with the remainder to be paid during a 10-year period.

Both sides say the outcome of the case could affect plans by many of the nation's 235 nonprofit HMOs to convert to for-profit status. So far this year, 73 nonprofit HMOs have converted to for-profit status, according to the Office of HMOs in the federal Department of Health and Human Services.

650,000 Subscribers

Maxicare, which converted to for-profit status four years ago, has 650,000 health subscribers in 11 states. The addition of FHP, with its 220,000 medical subscribers in Southern California, Utah and Guam and 70,000 dental subscribers, would significantly increase Maxicare's market share in two of its principal markets, Southern California and Salt Lake City.

FHP Chairman Dr. Robert Gumbiner said FHP had surplus revenue, the nonprofit equivalent of net earnings, of $14.8 million in the year ending June 30, up from $8.6 million in 1984 and $2.4 million in 1983.

In its suit, Maxicare argues that the highest offer represents fair market value and that FHP must accept the highest bid in order to convert. Maxicare Chairman Fred Wasserman said his firm's bid for FHP "will go up to between $60 million and $80 million" if it gains access to FHP's books.

In other cases, courts have held that, when charitable assets are sold, they must go to the highest bidder. But Gumbiner and FHP attorney John Houck said they do not believe that FHP must accept the highest bid.

The state Department of Corporations approved on Sept. 20 the bid by HMO Health Group, a company formed by Gumbiner and 17 other employee-investors, to assume FHP's business after the conversion. Gumbiner, who founded FHP in 1961 and also serves as its chief executive, owns 50.5% of HMO Health Group.

Although the Department of Corporations originally had proposed $47 million as the fair market value of FHP's assets, when it accepted the Gumbiner group bid, it agreed to value FHP at $36 million. It said it had calculated the price based on analysis of unaudited financial statements.

One study, filed by FHP's management with its conversion request to the Department of Corporations, estimated that, if FHP's charitable assets had been sold on the open market when HMO stocks peaked last spring, the assets would have been worth $216 million. FHP says the figure is now grossly overstated. Indeed, in trading Wednesday, prices of several health-care companies' stocks plummeted on predictions that the industry's period of rapid earnings growth had come to an end.

Gumbiner said that, if FHP is forced to accept Maxicare's higher bid, he will stop the conversion and remain a nonprofit organization. "Maxicare, which paid less than $300,000 when it converted four years ago, is attempting to make the law so that no one can convert," he said. "If Maxicare prevails, they would effectively establish a law that anybody wanting to convert would have to auction the assets, and then large companies would simply bid more than the fair market value to eliminate competition."

FHP attorney Houck said: "The conversion process is not an auction." Citing the 1980 state law authorizing conversions of HMOs to for-profit status, he said that FHP's directors "owe a duty in general to the public to pay the fair market value for the charitable assets, but they also specifically owe a duty to their subscriber group."

LA Times 10/19/85

To: FT

Judge OKs FHP's Buy-Out Plan, Thwarting Maxicare

By JUBE SHIVER Jr., *Times Staff Writer*

Over the state attorney general's protests, a Los Angeles Superior Court judge on Friday let officials of an Orange County nonprofit health maintenance organization proceed to buy their HMO and convert it into a for-profit concern even though rival Maxicare Health Plans offered to pay millions more.

Judge Eli Chernow's ruling came after Hawthorne-based Maxicare filed a lawsuit last month to force nonprofit FHP Inc. of Fountain Valley to accept its $50-million cash offer instead of a $36-million offer from FHP founder Dr. Robert Gumbiner and 17 other executives.

At stake in the case was the ultimate ownership and value of a nonprofit HMO that has enjoyed tax breaks and government support since its creation 24 years ago.

Maxicare's hopes were buoyed two weeks ago when a judge issued a temporary restraining order delaying Gumbiner's attempt to make FHP a for-profit concern.

Although the state Department of Corporations approved the purchase by the FHP executives in September, the state attorney general went into court Friday to press Maxicare's claim by seeking a preliminary injunction to prohibit the FHP executives from consummating their $36-million deal. That $36-million offer would pay $7.2 million in cash, with the remainder disbursed over a 10-year period.

But Judge Chernow, siding with the Department of Corporations and FHP, said: "An HMO conversion, under the law established by the Legislature, doesn't require sale to the highest bidder."

Maxicare, which converted to for-profit status four years ago, has 650,000 consumers enrolled in its health plans in 11 states. The addition of FHP, with its 220,000 members in Southern California, Utah and Guam, would have significantly increased Maxicare's market share in two of its principal markets—Southern California and Salt Lake City.

FHP still has some hurdles to overcome, however. Its Department of Corporations approval to convert expired on Oct. 7. And Gloria M. Richards-Johnson, corporations counsel for the department, said Friday that FHP will have to resubmit an application for conversion.

The department "will be looking for a new valuation . . . of (FHP's)

Please see MAXICARE, Page 2

MAXICARE

Continued from Page 1

fair market value," Richards-Johnson said, explaining that FHP founder Gumbiner and his colleagues could end up paying more than the $36 million that was approved last month.

William S. Abbey, a deputy attorney general, said the state has not decided whether to appeal the decision.

The controversial case was closely watched by experts in the $400-billion-a-year health-care industry because it could affect plans by many of the nation's 258 nonprofit HMOs to convert to for-profit status.

Said FHP spokesman Stuart Byer: "We are very happy about the decision. We looked at this as a 'David and Goliath' story. Here we had a very large HMO (Maxicare), which had converted to for-profit for a very negligible amount of money, trying to stifle competition by bidding up the buy-out."

73 Conversions This Year

So far this year, 73 nonprofit HMOs have converted to profit-making concerns, according to the Department of Health and Human Services' Office of Health Maintenance Organizations. However, most conversions have involved purchases by third parties, experts say, not by the directors or founders of the nonprofit HMO.

Nevertheless, many experts believe that Friday's ruling will preserve low health-care costs for consumers by maintaining competition in the HMO industry. That's because, they say, large investor-owned HMO chains won't simply be able to gobble up their nonprofit competition through bidding wars.

Since federal funds to establish and maintain nonprofit HMOs ran dry 18 months ago, all but the strongest nonprofit HMOs have become acquisition targets by their for-profit brethren, since it is cheaper to buy an existing HMO rather than build one from scratch.

"Other states look to California as to (legal) precedent, so this case is going to preserve a certain process under which HMOs are converted," said Joanne B. Stern, a law professor at the Whittier College School of Law, who writes about antitrust issues in the health-care field.

"It would have been a disaster if it had turned out the other way. There would have been a pubic bidding war for HMOs in every state."

Daily Journal

Section II

Monday, October 7, 1985

...e Courts

Milt Policzer

...tting Court Attention?

goes on to assert this is a common problem in Los Angeles County. We're not sure that's true (we've gotten through just fine lots of times), but there are certain things that can be done to get people's attention when necessary.

Busy practitioners may wish to try:

• Sending a stripper messenger. Nothing will get attention faster — and put a stop to other distractions such as arguments —than a suddenly naked man or woman in the middle of a courtroom delivering an oral message.

Some of you may wish to place your briefs on the messenger.

• Permanently stationing an associate in the courthouse with a walky-talky. An immense amount of time can be saved that way if the associate makes all appearances for the firm and delivers messages. You can also save on office space. And there's usually a law library close by for research.

• Sending flowers to the clerk. A little bribery can go a long way.

YOU'RE NOT SAFE ANYWHERE

Speaking of flowers, we found the following in a Los Angeles Superior Court complaint filed by a Northridge lawyer:

"At approximately 6:50 p.m. Plaintiff was in the Produce Department of the abovementioned supermarket, accompanied by her granddaughter. As she just walked past the fresh flower section, Plaintiff unknowingly stepped in some vomit that was left negligently unattended on the floor. Plaintiff slipped and fell on the floor."

Supermarkets never seem to have enough attendants.

...y Have No Suspects

A.G. Clashes With State Regulato... On Health Firm's $36-Million Deal

By GAIL DIANE COX

In an unusual step, the state attorney general's office has gone to court in Los Angeles and delayed the conversion — already approved by state regulators — of a non-profit health maintenance organization into a for-profit HMO.

Judge Eli Chernow granted a temporary restraining order Thursday, accepting the arguments of Deputy Attorney General William Abbey that FHP Inc. of Fountain Valley should not be allowed go though immediately with a plan to sell its assets to its founder and several key employees for $36 million.

The attorney general's intervention came in a lawsuit that has been filed by a rival health maintenance organization, Maxicare Health Plan of Hawthorne. Maxicare has made a cash offer of $50 million for FHP Inc., and is seeking a writ to force FHP Inc. to accept the higher bid.

Non-profit organizations do not pay taxes and when one converts to for-profit status, the buyer must in effect pay the public for the value of the organization's assets, which have been held in trust. Typically the payment takes the form of a contribution of the value of the assets to charities.

Maxicare attorney Fredric Zepp, who spoke briefly in favor of the restraining order, said in an interview that when charitable assets are sold, courts have held that they must go to the highest bidder. "We're not watchdogs for the public interest, but we hate to see charity cheated out of $14 million," he said.

Zepp added that before Oct. 18, the date Chernow set for a hearing on the merits of an injunction, he expects FHP to "fully consider our offer."

FHP attorney John Houck disputed the attorney general's entry in the matter, arguing that state statute makes the Department of Corporations the regulator of conversions. The law doesn't "comtemplate an auction to the highest bidder, but rather than the organization will continue under the same management," Houck said.

He added that the department had approved the $36-million offer only after independent determination of the value of FHP Inc. "The $50 million is an example of an offer made far above the fair market value to eliminate a rival," Houch asserted.

Behind-the-Scenes Talks

Chief Assistant Attorney General Andrea Ordin confirmed that she personally had tried to negotiate with the Department of Corporations behind the scenes to head off the courtroom clash between the two state agencies. She speculated that she was unable to get a recission or modification of the department's approval because court briefs had already been filed.

"I was and am concerned that charity was not getting its fair share," Ordin said, adding that she had been assured of "cooperation in the future."

Injured TV Stuntwoman Claims She Was Misled

United Press International

A stunt woman severely burned by a special effects explosion during filming of the "Airwolf" TV series has filed a federal court suit against Universal Studios, claiming the company misled her about the nature of the stunt.

Desiree Kerns, 28, filed the lawsuit Thursday, accusing the studios of racketeering and wire fraud.

The allegations were filed on the grounds that the studio and stunt supervisors inten-... [illegible]

Kroll, Kerns' attorney.

Wire fraud during interstate commerce is one of the crimes covered by the federal Racketeering, Intelligence and Organized Crime Act, Kroll said.

Kerns, of Los Angeles, suffered second and third-degree burns to her head, neck, face and an arm in the Feb. 25 accident at the Indian Dunes Recreation Area near Los Angeles.

She was hospitalized for two weeks and required skin grafts on her neck and face, Kroll said.

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September 16, 1985

VIA ZAP MAIL

Warren L. Barnes, Esq.
Department of Corporations
1107 9th Street
8th Floor
Sacramento, California 95814

Re: Maxicare Health Plans, Inc. ("Maxicare")/FHP, Inc. ("FHP")

Dear Mr. Barnes:

We appreciated the opportunity to make a preliminary inspection of the FHP public file on September 13, 1985. We look forward to inspecting the balance of the public file on September 18, 1985. I am writing, at this point in time, to review with you several items relating to Maxicare's pending bid for the assets of FHP.

1. Increased Bid for the Assets of FHP

Maxicare will submit to the Board of Directors of FHP, on or before October 3, 1985, an offer to purchase the assets of FHP at a price substantially in excess of Maxicare's September 6, 1985 offer. Although the exact dollar amount cannot be determined until the inspection of the public file is completed, Maxicare anticipates that its offer will, in all material respects, satisfy the $47,000,000 settlement amount suggested by Mr. Zablocki in his letter to FHP of September 3, 1985. As before, Maxicare will present an all-cash offer payable in full upon the closing of the transaction.

2. Inspection of the FHP Public File

We hope that your office will make available to us on September 18, 1985, the balance of the FHP file. In particular, Maxicare would like to review the Valuation Analysis from Ernst & Whinney received by your office on August 15, 1985. In addition, the file we inspected did not contain the most recent proposal from FHP's inside directors relating to the amount, terms and installment schedule for making a charitable settlement upon the proposed conversion of FHP.

I am enclosing a copy of Mr. Zablocki's letter of September 9, 1985, to Thomas R. Mueller, Esq. In that letter, Mr. Zablocki listed those portions of the FHP file which have been accorded confidential treatment by your office. In all probability, the decision to accord these materials confidential treatment was made prior to Maxicare's offer to purchase the assets of FHP. In light of this change in circumstance, Maxicare hereby requests, pursuant to Rule 250.10.5, that your office reconsider the decision to accord these documents confidential treatment. Maxicare requests that your office disclose items 1, 2, 3, 4, 7, 8, 9 and 10 of the items listed in Mr. Zablocki's letter on the grounds that the public interest in favor of disclosure clearly outweighs the public interest against disclosure.

Maxicare believes that all of the requested documents are relevant to a determination of the value to be paid to charity upon the conversion of FHP. If charity is to be fairly and adequately compensated, documents relevant to the determination of the fair market value of the FHP assets simply cannot be withheld from the public. If your office is of the view that disclosure of these documents to the general public is for any reason inappropriate, Maxicare is willing to enter into a reasonable protective order designed to accommodate any such concerns.

Maxicare's request that your office reclassify these documents should not be misconstrued as an attempt to obtain confidential information in the nature of trade secrets, such as plans by FHP for expansion into new markets. Indeed, if your office determines, and advises us, that the requested documents, or portions thereof, contain such trade secrets, Maxicare will withdraw its request for reclassification to that extent.

3. Applicable Legal Authorities

In prior telephone conversations, you have asked that I provide you with Maxicare's legal authorities for seeking the cooperation of your office. These authorities are set forth in some detail in Maxicare's court filings. Nonetheless, to summarize briefly, the legal authorities bearing on the merits of this controversy are as follows.

The conversion of a nonprofit public benefit corporation conducting a health care service plan into a general business corporation requires the advance written approval of the Department of Corporations pursuant to Corp. C. § 5813.5 and Corp. C. § 10821. Because the inside directors of FHP are proposing to issue stock upon the conversion of FHP to themselves, the proposed plan of conversion constitutes a self-dealing transaction under Corp. C. § 5233. Section 5233 provides a number of procedural safeguards designed to protect the nonprofit public benefit corporation from transactions with its directors which would be unfair to the corporation. Among other requirements, Section 5233(d)(2)(D)(i) provides that:

> Prior to authorizing or approving the transaction the board considered and in good faith determined after reasonable investigation under the circumstances that the corporation could not have obtained a more advantageous arrangement with reasonable effort under the circumstances. (Emphasis supplied.)

Maxicare submits that a "more advantageous arrangement" is presently available to FHP in the form of Maxicare's all-cash offer of September 6, 1985, to pay $30,000,000 for the assets of FHP. More to the point, Maxicare's preliminary review of the FHP public file has led Maxicare to conclude that its first offer is priced at less than the fair market value of the assets of FHP.

Accordingly, Maxicare in the very near future will substantially increase its offer for the purchase of the assets of FHP.

The law is clear that the directors of FHP have duties of loyalty and of reasonable care which dictate that they seek to obtain the best price obtainable for the assets of FHP. Corp. C. § 5231. Section 5233 of the Corporations Code requires that these directors make a "reasonable investigation" to determine whether a "more advantageous arrangement" is available with "reasonable effort under the circumstances." In short, the law imposes upon the directors of FHP an affirmative duty to test the market and if they fail to do so they will be held responsible. See, e.g., Rippey v. Denver United States National Bank, 273 F. Supp. 718 (1967) (discussing in some detail the duty of a trustee to test the market when there is knowledge of a second potential buyer willing to pay a higher price).

The Board of Directors of FHP cannot approve the plan of conversion proposed by the inside directors of FHP unless and until they have determined that a purchase by Maxicare would not constitute a more advantageous arrangement for the charitable corporation. Your office has a duty to enforce this standard of care. At a minimum, this requires that your office verify whether the FHP Board of Directors has "tested the market" prior to its acceptance of the FHP inside directors' plan of conversion. If not, your office has a clear and present duty to disapprove the FHP conversion until such testing occurs.

4. Antitrust Considerations

Based on information currently available to us, it appears that Maxicare's offer to purchase the assets of FHP is subject to the Hart-Scott-Rodino pre-merger notification rules. Under these rules, the purchase cannot take place until the Federal Trade Commission reviews the proposed transaction for antitrust compliance. We will, of course, prepare the required filing and submit it to the Federal Trade Commission in order for that office to do an antitrust review. We are confident, based upon our current review, that the acquisition of the assets of FHP by Maxicare will not present any difficulties under the antitrust laws. If your office decides to consult the Attorney General's office for an independent review of the antitrust considerations, we will be pleased to supply you with any information you deem necessary.

In conclusion, Maxicare would like to urge all concerned to approach this problem not as hostile advocates attempting to defend litigating positions, but with a recognition that we are in uncharted waters with but a single landmark to guide us, i.e., the duty to maximize the value to charity. In that spirit, we offer to meet at any time and to provide whatever assistance we can to expedite a resolution of this matter. We hope that all interested parties will reciprocate.

Very truly yours,

Albert R. Rodriguez

Albert R. Rodriguez
of LATHAM & WATKINS

cc: William S. Abbey, Esq. (w/encl.)
Thomas R. Mueller, Esq. (w/o encl.)

-- Zablocki

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*MEMBER OF DISTRICT OF COLUMBIA BAR ONLY

June 5, 1984

The Hon. Lloyd Connelly
State Assembly
STATE CAPITOL
Sacramento, CA 95814

Attn: Mr. Gilbert Foster,
Administrative Assistant

HAND DELIVERED

File: 06670.106

Re: Conversion of Foundation Health Plan.

Dear Assemblyman Connelly:

At the request of our client, Foundation Health Plan, and at the request of Michael Zablocki, Esq. of the California Department of Corporations ("DOC"), we are responding to your request for information on the conversion of Foundation Health Plan of Sacramento from nonprofit to for-profit corporate status and the effect that the transaction may have on consumer benefits.

Historical Perspective and Motivations for Conversions

Although California now permits the development of for-profit HMOs, this was not the case in the past. Until 1975 when the current enabling legislation, the Knox-Keene Act, was passed, California required that prepaid plans be organized as nonprofit entities. Thus, to a large extent, the development of a nonprofit structure was dictated by state law and not the result of a choice by the HMO organizers. Even after the adoption of the Knox-Keene Act, many HMOs still chose to select nonprofit status. One reason was the unavailability of private sector financing for

3118

HMOs and the availability of generous grants and loans from the federal Office of Health Maintenance Organizations for the development and expansion of nonprofit entities.

Through the federal grant and loan programs, the federal government played a key role in stimulating HMO growth. Through fiscal year 1981, federal support totalled ONE HUNDRED FORTY-FIVE MILLION DOLLARS ($145,000,000.00) for six hundred fifty-seven (657) grants and ONE HUNDRED EIGHTY-FIVE MILLION DOLLARS ($185,000,000.00) for eighty-five (85) loans and loan guarantees. Over one hundred (100) plans received federal support for their initial development, much of this serving as the only source of "venture capital" for new HMOs.

In 1981, the Secretary of Health and Human Services announced that the federal effort to stimulate HMO growth had succeeded and that it was time for a reassessment of the federal program. The Reagan administration believes that support for HMOs must ultimately come from the private sector; thus, in 1981, direct federal financial support for HMOs began to end. Grants were no longer made after fiscal year 1981 and the federal loans were originally expected to end in 1983, but have been extended at least through 1984. (See Attachment "A".)

The federal government realized that private investors knew very little about HMOs and so as part of their promotional effort to foster the "privatization" of the HMO industry, the Office of Health Maintenance Organizations undertook a broad promotional effort to inform potential investors of HMO opportunities and to increase the private funds available for new and expanding HMOs. This program included: the publication of the "Investors Guide to Health Maintenance Organizations" by OHMO (see Attachment "A"); a revision of federal policies on grant and loan repayment to "indicate a greater flexibility in negotiating settlements of grants and loan obligations in acquisitions or conversions to for-profit status of federally-funded, not-for-profit HMOs," and the provision of technical assistance to HMO boards and management in evaluating the possibility of converting to for-profit status or other methods of attracting entrepreneurial sponsors.

According to a speech presented to the National Health Lawyers Association by Whittier College School of Law, Health Law Professor Joanne B. Stern, by 1981, at least five (5) California HMOs had actually converted to for-profit status and at least a half dozen more were in the process of doing so. (See Attachment "B".)

Approximately twelve (12) months ago in this environment of decreasing federal support of HMOs, and increasing private investor interest in HMOs, the Board of Directors of Foundation Health Plan began evaluating the range of options available for its continued growth and fiscal viability. (See Attachment "C".) Realizing that national networks or chains of HMOs were clearly the wave of the future (see Attachment "D"), FHP made the decision that to effectively compete with the national chains, the organization would have to expand; and that to expand, it would have to have substantial capital, which could no longer be obtained from the federal OHMO program. The decision was made to convert the HMO to for-profit corporate status.

Conversion

The California Corporation Code provides a mechanism whereby a not-for-profit corporation can convert to for-profit status. In the case of health maintenance organizations, the law requires the converting entity to file a Notice of Material Modification with the Department of Corporations and, until 1984, required the Attorney General to approve the conversion as well.

In order to obtain nonprofit tax status under state and federal law, a nonprofit corporation must include in its Articles of Incorporation, a "dedication" provision, which states that the property of the corporation is irrevocably dedicated to charitable purposes and, upon dissolution or winding up of the corporation, its assets will be distributed to a nonprofit fund, foundation or corporation, which is organized for charitable purposes. Furthermore, none of the net earnings of the corporation may "inure to the benefit" of any individual. Both the Department of Corporations and the Attorney General have taken the position that, as a result of such dedication provisions, a conversion cannot be approved without a "charitable trust settlement." The DOC and the Attorney General assess the tangible worth of the Company in view of its present assets and profitability, the goodwill value of the company, and prior trust violations, if any, in arriving at a "valuation" of the corporation for purposes of the charitable trust settlement. The settlement amount must then be distributed to a nonprofit fund, foundation or corporation, organized for charitable purposes.

After extensive negotiations with the Department of Corporations, a valuation of FHP was established. FHP met this charitable trust obligation by creating Sierra Foundation for Health ("SFH") as a nonprofit corporation, contributing ONE MILLION DOLLARS ($1,000,000.00) in cash to SFH in consideration of the conversion, and issuing all of the common stock of the converted corporation to SFH.

AmeriCare Health Corporation (a management/holding company formed to facilitate expansion of the HMO business into other states) was incorporated in January 1984; it became capitalized at the date of conversion of FHP by the issuance of two million five hundred thirty-six one hundred forty-eight (2,536,148) shares of its common stock, along with a guarantee of the value of those shares, to SFH in exchange for all of the outstanding shares of FHP.

This approach offered several advantages: it permitted the establishment and initial funding of a new foundation (Sierra Foundation for Health) dedicated to promoting health and health-related activities in northern California; it provided a permanent source of revenue for that foundation through stock dividends and the revenues from occasional public offerings of shares; it meant that if the stock appreciated in value substantially, the Foundation could realize far more money then the amount negotiated as the charitable trust settlement; and it would accomplish all of this without draining the cash reserves of the HMO or jeopardizing the financial solvency of the Health Plan.

Furthermore, because the reorganization was accomplished by means of conversion to for-profit status, rather than by merger, consolidation or some other method of reorganization, the HMO continued operations without disruption, was not required to be relicensed by the state or requalified by the federal government, and was therefore able to maintain its existing contracts with both consumers and providers. The rights and benefits of FHP enrollees remain unchanged. The only impact on enrollees that is expected to result from the conversion is a positive one: as the holding company acquires additional HMOs and is able to spread the risk of providing care over a broader base of enrollees, the result should be, at a minimum, premium stabilization and hopefully premium reduction.

Physician Reaction to the Conversion of FHP

Shortly after FHP announced the conversion to for-profit status, the Sacramento-El Dorado Medical Society published an article in its newsletter describing the conversion and suggesting that the charitable trust settlement represented a diversion of funds which should have been distributed either to the approximately one thousand five hundred (1,500) participating physicians in the form of additional return of "physician withholds" or to the enrollees in the form of reduced premium. The Society suggested that the ability of FHP to have accumulated over FIVE MILLION DOLLARS ($5,000,000.00) in "profits" was proof that the consumer had been overcharged and the physicians underpaid.

The characterization of the charitable trust settlement as "profits" of the organization was of course erroneous. The charitable trust settlement represents an approximation of the "fair value" of the corporation, goodwill, and to some extent prospective profitability -- as opposed to "profits" of the corporation. The suggestion that the money could have been returned to the physicians or the consumers was also erroneous, given the charitable dedication requirement. While it is true that the HMO maintains substantial cash reserves, these reserves are amounts required to be maintained by federal and state regulation to guarantee the financial viability of the plan and to protect the subscribers from being billed for services in the event the HMO goes insolvent and is unable to pay physicians or hospitals. For accounting purposes reserves are considered obligated funds. (See Attachment "E".) The distinction between "profits" and reserves is most clearly evident in the limitations imposed by law on the use and investment of reserve funds.

In establishing the premium for an HMO, state and federal law require that the premium be established at a high enough level to permit the accumulation of reserves. Again, the goal is not to provide windfall "profits" to the HMO, but to assure that the plan has sufficient cash reserves to meet unexpectedly high health care expenses and to ensure that the consumer does not lose health care coverage due to the insolvency of the HMO. The Medical Society's suggestion that FHP should have lowered premiums rather than accumulating such sums, ignores the legal and business need for maintaining substantial reserves. The Society also ignores the fact that FHP's premium will have increased only two percent (2%) in the two (2) year period ending December 31, 1984 compared to industry increases of some thirty-five percent (35%).

With regard to the Medical Society's allegation that the charitable trust settlement represented funds which the HMO had obtained by withholding partial payment from the physicians, the allegation misrepresents both the character of the charitable trust settlement and of the physician withhold.

In order for a health maintenance organization to receive federal qualification, the HMO must provide evidence to the Office of Health Maintenance Organizations that it has imposed "mechanisms, such as risk sharing, financial incentives, or other incentives, to be applied to monitor utilization and to control costs of basic and supplemental health services and to achieve utilization goals." The purpose clause of the Knox-Keene Act, pursuant to which HMOs are licensed in the State of California, states that the intent of the HMO enabling law is, among other things, "helping to assure the best possible health care for the public at the lowest possible cost by transferring the financial risk of health care from the patient to the providers."

These laws recognize that the HMO cannot contain the cost of care unless the physicians bring utilization of health care services under control. To ensure that physicians do not over-utilize health care services in an attempt to increase their fees, the concept of risk sharing was developed. The most standard method of risk sharing in an IPA model HMO, such as FHP, is the physician withhold. (See Attachment "F".) The physician is paid at or slightly below his or her normal fee for service rate, but a percentage of that fee is withheld until the end of the year when the HMO can be assured that its premium income was sufficient to pay all of the bills for health care services. If, after paying administrative expenses, meeting state and federal reserve requirements, and reimbursing hospitals and health practitioners, the HMO has not had to tap the reserve account containing the physician withhold, that amount of money is retained or distributed according to a pre-arranged schedule or contractual arrangement. Some arrangements provide that the amounts in the withhold account are shared between the HMO and the physicians, reflecting the fact that the HMO's role in monitoring utilization and reporting problems to the physician plays as important a role in controlling utilization as does the physicians' efforts. By the same token, if the amounts in the physician withhold account are insufficient to cover losses caused by over-utilization, the losses are generally shared between the HMO and the physicians to the same extent that surpluses are shared.

In devising its risk sharing mechanism, FHP adopted a more flexible approach. Payments for services by the Sacramento physicians are subject to a withholding of ten percent (10%). To the extent that this ten percent (10%) withhold does not cover the cost of excess utilization, the HMO bears the entire risk of loss beyond the ten percent (10%) withhold. The physicians risk is thus capped at ten percent (10%) of their fee. To the extent that amounts remain in the withhold account after payment of expenses, the Board of FHP is responsible for determining what portion of the withhold should be distributed to the physicians. Under no circumstances, according to the physicians contract (Attachment "G," Section 9), can the withhold funds be distributed if such distribution would impair the standing of FHP under the minimum Tangible Net Equity requirements of the Knox-Keene Health Care Service Plan Act of 1975. Thus, until FHP reached "break even" and had established sufficient reserves, no distribution of withhold funds was permissible, or expected, under the contract. In 1983, the first year after break even, the FHP Board exercised its discretion to return all or part of the physician withhold by returning one hundred percent (100%) of all amounts in the withhold account. Unless unexpected, catastrophic expenses are incurred in the second half of 1984, it is the Board's intention to distribute one hundred percent (100%) of the withhold in 1984, as well.

Stock Purchase Plan

In recognition of the important contribution made by the physicians to the success of Foundation Health Plan and the importance of maintaining continuity in the provider panel, the conversion plan for Foundation Health Plan proposed that the physicians be given an opportunity to share in the profits of the for-profit corporation by purchasing stock in AmeriCare Health Corporation, the management/holding company. According to the recent registration statement filed with the Securities and Exchange Commission (but not yet approved and therefore subject to amendment and change). AmeriCare Health Corporation proposes to offer shares of AmeriCare stock to FHP's participating providers. After completion of the Offering, physicians would own approximately twelve percent (12%) of AmeriCare. Their shares will be restricted for resale for a period of time.

A stock Plan has been formulated for FHP's management, which is designed to keep and attract management level personnel who are committed to the success of the HMO. Thus, under the proposal submitted to the SEC, management will be offered both restricted shares to purchase and options, which can only be exercised twenty percent (20%) per year commencing one year after the effective date of the Offering. The stock purchases are restricted in that management may only sell twenty-five percent (25%) per year commencing one year after date of purchase. After completion of the Offering, if physicians and management purchase all of the shares offered, Sierra Foundation for Health would own approximately seventy-nine percent (79%) of the outstanding shares; the physicians would own approximately twelve percent (12%) and management would own approximately eight percent (8%). By the end of the fifth (5th) year, if management exercises all of its options to purchase shares and no other stock is sold, management would own approximately twenty percent (20%) of the outstanding shares. The intent of the plan is to provide an incentive for employees to work for the success of the corporation, to bind them to the company in the future and to provide an incentive to attract new management talent to the organization.

All of the shares to be offered to management and physicians have the same voting, dividend and liquidation rights. Furthermore, management and physicians would be offered their respective shares at the same time and at the same exercise price. The exact price has not been established, pending discussions with the SEC.

Conclusion

The conversion of Foundation Health Plan from nonprofit to for-profit status was part of a nation-wide trend by HMOs (see Attachment "H") to attract private sector capital following the termination of federal funding programs. The conversion was unique only with respect to the size and financial position of the HMO involved and the innovative approach formulated to meet the charitable trust settlement requirement without draining the capital resources from the HMO. As a result of the conversion:

- o Northern California can now boast of having one of the largest charitable organizations in the state, whose revenues from the ownership of AmeriCare stock have a potential of far exceeding the charitable trust settlement established by the state;
- o Foundation Health Plan remains a federally-qualifed, state-licensed HMO, dedicated to providing the highest quality of health care to its enrollees while working actively to contain the escalating cost of health care;
- o FHP has been reorganized to better compete for private sector investment capital and for enrollment, despite the cutback in direct federal financial support for HMOs;
- o Consumer rights and benefits have been unchanged, but the solvency of the HMO and the prospect for premium stabilization through spreading of the risk of providing health care services have been enhanced by the creation of an organizational structure geared towards controlled expansion;
- o The risk of providing health care services, which by law must be shared by the physicians (who still number approximately one thousand five hundred (1,500) after conversion, see Attachment "I"), should be substantially reduced as the HMO expands its enrollment, its reserves and its asset base.

Before the conversion was accomplished, the entire conversion plan was approved by the federal Office of Health Maintenance Organizations and the California Corporations Commission. As part of its approval process, the Department of Corporations was primarily concerned with the ongoing viability of the HMO, and concomitantly, the impact that the conversion might have on the HMO's enrollees, and with the charitable trust obligation and the manner in which it was satisfied. The past history of FHP was also reviewed to ensure that it had not committed prior charitable trust violations as a result of unfair dealings between the HMO entity and any affiliate or related parties. After extensive review, which lasted over five (5) months, both of the agencies authorized the conversion.

FHP has attempted, through correspondence with the physicians and its enrollees, to assure all interested parties that the conversion of the HMO was a necessary step in the growth of the corporation, and will ultimately benefit not only the corporation, but its participating physicians and enrollees. We would like to assure your office of our complete cooperation in your efforts to respond to the questions raised by your constituents.

It has been our intent to respond to the questions which you raised in your telephone conversation with Michael Zablocki, Esq. and in your subsequent communication with Sheila Maloney of this office. If you have any further questions, or if you require further clarification on any of the matters addressed in this letter, please do not hesitate to call me or Sheila Maloney at 925-2500.

Sincerely,

STOCKMAN LAW CORPORATION,
a professional corporation:

By: Walter E. Stockman
WALTER E. STOCKMAN

WES:SAM:ces
cc: Michael Zablocki
George Deubel
Steven Tough

Memorandum Re: Discussion of "Fair Market Value" vs. "Stated Book Value"

"Fair market value" is defined as the price at which property changes hands between willing and knowledgeable parties, both having an understanding of the facts and circumstances.

"Stated book value" can be defined as the total Stockholders' Equity as reported on financial statements in accordance with generally accepted accounting principles as of a particular point in time.

The true value of a company from an investor's standpoint is based upon its ability to generate cash for its shareholders. The investor is concerned about his return on his investment relative to the risks involved.

"Stated book values" or "accounting" book values of a financial institution do not necessarily represent the actual value of the business. For example, the loan portfolio may be recorded on the books for $50,000,000. However, it may only be worth $45,000,000 due to the interest rate, average yield and collectibility of those loans. Due to generally accepted accounting principle guidelines, leases may not be recorded on the books. Accordingly, undervalued assets or liabilities may not be reflected in the "stated book value."

Instead of looking at the book value of the assets and liabilities, the shareholders and the Board of Directors, as fiduciary representatives of the shareholders, should look at the earnings capacity of these assets and the true cost of the liabilities. One method of estimating this is to determine what the assets and liabilities can be sold for. The income earning ability of the assets is reflected by the price someone will pay for the asset. For example, a buyer will pay $5,000,000 for a loan portfolio only if he can earn more than $5,000,000 with the portfolio. Conversely, a buyer will not pay a premium of $1,000,000 for deposits unless he can invest and earn $1,000,000 **more** than the cost of funds of those deposits.

The financial institution may also have other assets that are not clearly identifiable from the balance sheet. Examples are:

- Superior management team
- Market penetration or niche market share
- Low cost of funds

Valuing these assets is more difficult than valuing hard assets. The value of these assets also is determined by the earnings they can generate. Generally, forecasted income statements and balance sheets are used as the basis for incorporating the value of these assets in the value of the business.

More importantly, value for a business such as a financial institution is really driven by soft assets such as people and financial services and not by machinery and tangible products. Accordingly a transaction to be proposed to the shareholders of the institutions, at the recommendation of the Boards of Directors, should be based upon a technique that reflects "fair market value" if the Boards of Directors are to meet their fiduciary responsibilities.

Thus, the "values" of the outstanding common stock of the financial institutions will differ from the stated book value to the extent that fair market value of hard assets (equipment and real property etc.) and intangible assets (people, management, market share etc.) differs from book value. Also, the "values" of the outstanding common stock of the combined financial institutions may differ from the "values" of the institutions as "stand-alone" entities.

In a stock-for-stock merger such as this, the "partners" each contribute an amount of fair market value. If the contributions of fair market value are different, the difference is usually reflected by the exchange ratio of the contributing stock of the two institutions.

Depending upon the outcome of the valuations, it may be necessary to adjust the share exchange ratios as they should be based upon "fair market value" and not "stated book value". There is the possibility that "fair market value" may equate to "stated book value." However, it is the responsibility of the Boards of Directors to assure that the transaction takes place at "fair market value" in order to avoid shareholder suits.

PEAT MARWICK

Focus on
Mergers & Acquisitions

It's often necessary, though seldom easy, to evaluate a going business when its shares do not trade publicly. The best ways to approach this task are described in this article. Every method must be backed up with judgment.

WHAT'S MY BUSINESS WORTH?

Stephen Blum and Cynthia Morrison
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The question asked by the title of this article can be pivotal in the managing of any company, especially if it is privately held. Several factors may compel the owner or investor to measure what may be his or her only important investment and source of income. The following list gives some of the reasons for business valuations.

Reasons for a Business Valuation

- Purchase or sale of a business or business segment
- Estate planning
- Strategic planning: resource allocation between business segments
- Employee stock ownership plan
- Tax calculation support (gifts, contributions, etc.)
- Recapitalization or new financing
- Required distributions by private foundations
- Management incentive plans
- Shareholder buy-sell agreements
- Litigation

Gauging the worth of a business is often easier in theory than in practice. Take the apparently straightforward concept of fair market value, the price at which property would change hands between two willing and knowledgeable parties both aware of the relevant facts and circumstances. Although economists and financial experts bandy about the term with utter confidence, until a transaction actually occurs, fair market value must be estimated indirectly, through hypothesis and comparison. The challenge is even greater if the property is a closely held business: there is no daily trading in its shares to provide an analytical starting point. Indeed, it is hard to value even publicly traded businesses, as shown by the wildly varying premiums offered by acquirers in order to gain control of such businesses.

Still more complications are likely to cloud the valuation of a privately held business. It may occupy a unique market position. Financial planning may have been aimed at reducing taxes rather than maximizing profits. The business may depend on an energetic and charismatic owner-manager. Formal projections or even budgets may not exist. Transactions with affiliated businesses may distort the financial picture.

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The "right" answer is hypothetical
Where does this leave the private business owner who doesn't know what the investment of a lifetime is worth? Fortunately, there are several common methods of business valuation. Sometimes, a single method will be best suited; at other times, a number of perspectives can be combined to develop an estimated range of fair market value. At all times, numerous assumptions and adjustments are needed. There can be no "right" answer without an actual sale of the business.

One should investigate several analytical valuation methods in order to ensure that the estimate of value is (1) objective, (2) relevant, and (3) adequately documented. Objectivity is needed to remove the impact of personal involvement, or "gut" feelings. Relevance is crucial if the analysis is to provide real guidance to whoever uses it. Documentation reinforces the overall credibility of the analysis.

* These four generally accepted business valuation methods have received wide attention:

- Discounted cash flow analysis
- Asset appraisal
- Acquisition analysis
- Comparison to similar publicly traded companies

Consider the advantages and drawbacks of each of these approaches. This will reveal which methods are better suited to various valuation needs.

DCF relates the present to the future
Discounted cash flow (DCF), or net present value, analysis has been highly publicized as a method of assessing business value. The method consists of relating future cash flow to fair market value. The theoretical foundation of DCF analysis is constructed from at least three hypotheses:

1. Cash now is worth more than an equal amount of cash in the future.
2. Future cash flows (e.g., from business operations) are reasonably predictable.
3. The marginal cost of capital available to the business, and its alternative returns on invested capital, are similar and are subject to estimation.

DCF analysis is an elegant theoretical method for translating cash-generating capacity into value at present. Few business owners would question the first of the three underlying hypotheses. The other two, however, do not always hold when DCF analysis is applied to an operating business.

Cash flows may be difficult to predict in businesses facing rapid change, heavy capital requirements, regulatory shifts, volatile product price swings, or similar uncertainties. A time frame must be assumed. Proceeds from disposing of the business at some future date must be estimated. Many privately held businesses do not regularly prepare projections.

In any case, the cost of capital and the return from alternative investments are functions of the desired risk level and are unclear in times of fluctuating interest rates. Also, the true cost of equity capital is hard to quantify.

In certain business activities, such as real estate or insurance, DCF analysis is extensively relied on because cash flow in these activities has been historically more predictable.

How does DCF measure up in terms of objectivity, relevance, and documentation? Since many investments are evaluated by the cash returns they yield to investors, DCF analysis of a business can be highly *relevant*. When projections are available and research has been performed on capital costs and investment returns, DCF analysis can be *documented*. In terms of being *objective*, however, a DCF approach is often vulnerable to attack because of the likelihood that a number of key assumptions are highly subjective and will greatly affect the resulting value on a DCF basis.

If the whole is the sum of the parts . . .

A second frequently used business valuation method is the appraisal of corporate assets, net of liabilities. From an accounting standpoint, the method consists first of analyzing the balance sheet, isolating categories of assets and liabilities and identifying any unstated assets and liabilities. Fair market values are assigned to each category and then to intangible and unstated items, based on professional appraisals, reliable market data, and estimates. The resulting amount, often referred to as the net asset value, may provide an asset-oriented perspective on the fair market value of a business.

The asset appraisal approach is particularly well suited to businesses which derive value from underlying assets rather than from the prospect of an earnings stream. This may be true when there is substantial investment in real estate, a large proportion of marketable securities, or the intention to liquidate part or all of the company. Most other businesses derive value from their ability to generate future earnings, rather than intrinsically from their net assets. Valuing these businesses requires the use of other methods instead of, or in conjunction with, asset appraisals.

The asset appraisal approach often necessitates the participation of several appraisers, each with a specialized knowledge of a category of assets or liabilities. For example, real estate could be handled by one appraiser, machinery by a second, inventory by a third, pension accruals by a fourth (probably actuaries), and intangibles by a fifth (possibly with expertise in evaluating research efforts, patents, or the like). Each appraisal can be done on several bases, such as, in the case of buildings and machinery, liquidation value, replacement cost, or depreciated replacement cost. The valuation of a business as a going concern is usually incompatible with liquidation-basis asset appraisals. Rather, assets must be appraised under the assumption that they will continue to be used in the normal course of business.

Can the asset appraisal method of business valuation be objective, relevant, and documented? If the various asset and liability categories are fairly ordinary and subject to analysis by outsiders, then *objectivity* is possible. Many, if not most, going business concerns also derive significant value from intangible or "hidden" assets: customer lists, patents, research projects, reputation, goodwill, and so forth. These assets are much less prone to direct appraisal, which limits the impact of an asset appraisal approach to business valuation.

As to *relevance*, asset appraisal is less suitable in cases where future earnings, rather than appreciation in asset values, are the main goal. The approach usually has at least some relevancy in the sense that, when earnings are depressed, the value of a business may be buoyed by the worth of its assets or conversely, when earnings grow at extraordinarily high rates, asset values may act to retard the overall increase in business value. In the former case, the prospect of liquidating or divesting rather than continuing to operate at sub-par levels may contribute to the buoying effect on value; in the latter case, the potential tax impact of trying to transfer the benefits of higher earnings directly to investors may contribute to the retarding effect on value (e.g., capital gains, depreciation and investment tax credit recapture, and extraordinary goodwill).

In terms of *documentation*, the asset appraisal approach to business valuation may incorporate studies by outside appraisers, unless the assets are unique or nonquantifiable. The documentation process can be expensive and time-consuming if several experts are required.

What's today's market for businesses?

A third generally accepted valuation approach is to analyze purchases of similar businesses. This approach requires a careful survey and screening of publicly available data on recent acquisitions. With this information, perhaps in the form of a sample of five to ten acquisitions, one can identify relationships of the price paid for each business to its underlying characteristics, such as recent earnings, net assets, revenue growth, location, and acquisition structure.

In many industries, rules of thumb exist for estimating value. Newspaper publishers for example may be priced according to a multiple of circulation, gas station chains according to a multiple of gallons pumped, and fast food chains according to a multiple of weekly revenues per outlet. Persons familiar with a given industry or industry segment usually know these rules of thumb. Often, an acquisition analysis will combine rules of thumb and financial relationships.

The strength of this valuation method is that it draws on actual business transactions between willing and knowledgeable purchasers and sellers — closely approximating the definition of fair market value. Drawbacks to this approach, for which adjustments can sometimes be made, include: the distortions in selling prices caused by peculiar negotiating circumstances; unique acquisition structures or synergies; the relatively low frequency with which comparable acquisitions may occur; and the lack of published detail on acquisitions of or by closely held companies.

With these pros and cons in mind, one can measure the objectivity, relevance and documentation inherent in acquisition analysis as a business valuation method. The method is *objective* in that its inputs consist of *de facto* relationships between fair market value and underlying business characteristics. Acquisitions are historical events, not tenuous hypotheses.

The method is *relevant* when there exists a sufficient number of acquisitions of similar businesses, or acquisitions with similar financial and operational features, to permit the identification of important trends and relationships.

A *documented* analysis of acquisitions may be hard to develop. If the seller has been publicly held, or if the acquirer is publicly held and issues stock to pay for the acquisition, the disclosure requirements of the Securities and Exchange Commission provide a ready and comprehensive source of publicly available information. Otherwise, documentation of acquisition ratios, multiples, etc., may be inaccurate, difficult, or impossible. This is usually the case; in 1980, more than 85 percent of all U.S. acquisitions involved privately held sellers, according to W. T. Grimm & Co., a financial consulting firm.

The stock ticker tells a tale

A fourth popular valuation approach is to compare the business being valued to publicly held companies with similar financial, operational, and marketing environments. Why publicly held companies? Because these companies must regularly disclose details of their activities to the investing public, which in turn assigns a fair market value to shares of these companies through

Who Values Business?

Valuation Source	Basis of Valuation Expertise
• Appraisers	• Extensive exposure to most business activities • Understanding of asset appraisal techniques • Long-time reputation as an independent and professional valuation source
• Financial intermediaries	• Frequent contact with merger/acquisition situations • Corporate financial specialization • Experience in negotiating and pricing deals
• Accounting firms	• Industry specialization • Familiarity with a wide range of interrelated business problems • Financial statement analysis

Exhibit I
Business Valuation: Four Methods